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RAIL INDUSTRY/STAGGERS ACT OVERSIGHT

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SURFACE TRANSPORTATION

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

OVERSIGHT OF THE RAIL INDUSTRY AND THE STAGGERS ACT

JUNE 9, 17, AND 24, 1987

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RAIL INDUSTRY/STAGGERS ACT OVERSIGHT

TUESDAY, JUNE 9, 1987

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
SUBCOMMITTEE ON SURFACE TRANSPORTATION,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:05 p.m., in room SR-253, Russell Senate Office Building, Hon. J. James Exon (Chairman of the subcommittee) presiding.

Staff members assigned to these hearings: Robert Holleyman, staff counsel; Sheryl Washington, professional staff member; and Alan Maness, minority prorfessional staff member.

OPENING STATEMENT OF SENATOR EXON

Senator EXON. The Subcommittee will please come to order.

Today the Surface Transportation Subcommittee begins a series of three hearings on the Rail Industry and the Staggers Act.

This is an important set of hearings since it will provide the Subcommittee with testimony on a number of issues which have received considerable attention.

In an effort to deal with the breadth of the interest in this whole area, the hearing schedule has been generally divided into three parts. Today's hearing will concentrate on the financial health of the rail industry.

On June 17, the Subcommittee will receive testimony on the Interstate Commerce Commission's implementation of the Staggers Rail Act.

Finally, on June 24, we will hear from witnesses on the legislative proposals to amend the Staggers Act. Although there will be some intermixture among the witnesses and the testimony during these hearings, it is my hope that through this vehicle, these issues will be thoroughly ventilated.

We are beginning this series of hearings with today's inquiry into the financial well-being of the rail industry since this is the issue which cuts across all of the others.

The industry's financial status affects not only the railroad shareholders, but also the quality of service to shippers and jobs for railroad workers.

The scope of today's inquiry will be broad. It will include testimony about a variety of factors affecting the railroad industry, many of which fall outside the specific jurisdiction of the Senate Commerce Committee.

Nevertheless, these are all issues which, in the eyes of our witnesses, affect the financial well-being of the industry and in which we have a keen interest.

I might add, however, that we will be paying particular attention to the principal issues over which we have control. This is the Staggers Act, its success in revitalizing the rail industry and what the ICC's implementation of the act means for railroad workers and shippers.

I look forward to hearing from the witnesses who are scheduled to testify today and during the next several weeks. Their testimony will be a significant addition to the debate on these important issues.

Before I call the first panel, I would be glad to yield to my colleague from West Virginia, Senator Rockefeller, for any opening comments that he might have.

OPENING STATEMENT BY SENATOR ROCKEFELLER

Senator **Rockefeller**. Thank you very much, Mr. Chairman.

As I always do, I commend your leadership in holding this hearing today as well as the subsequent two. I also congratulate you for mapping out a strategy here. From my point of view, what I would like to see is a proper foundation, which will be put into place, in order for the consideration and markup of legislation that I have introduced with 10 other members of the Senate, and that is the Consumer Rail Equity Act.

Mr. Chairman, Harley Staggers, Sr., served the needs of my people in West Virginia in the other body for some 32 years. To continue the tribute to this fine gentleman, this committee must make the Staggers Rail Act work as he and as the Congress, in fact, intended. And this is to fairly balance the interests of shippers, of railroads, and of consumers, while maintaining a healthy and an efficient rail system.

I recently read an interesting insert in the Congressional Record. The Chairman of this full Committee, commenting on the successes and failures of deregulation of various industries, expressed his hope that the aura of deregulation for the sake of deregulation would be over, and that it was finally going to give way to common-sense views that some of the problems caused by deregulation also need some attention.

He put a quote on the end of his statement, where he said, "When the toaster keeps burning the toast, you fix it."

Mr. Chairman, the coal producers in my State of West Virginia and throughout Appalachia are being burned by the ICC's failure to protect them from railroad monopoly power, and they are not alone.

Grain farmers in the Plaines States and shippers of bulk commodities throughout this Nation find themselves in the same predicament and subject to the same unfathomable process at the ICC.

The reason that the shippers and the consumers supported the Staggers Rail Act in the first place was to get the railroads out of the bankruptcy courts, not to trade places with them. Everyone recognized that the enormous flexibility built into the deregulatory framework could be helpful so long as it was not abused.

Everyone also recognized that such extensive deregulation would leave some shippers particularly vulnerable, that is, those who were captive to a single railroad.

In short, Congress intended for the ICC to be vigilant in protecting those shippers who would be subject to the monopoly power of the railroads.

Let me make it clear, Mr. Chairman. I do not blame the railroads for trying to maximize their profits from captive shippers. They are behaving and acting like the father of capitalism—and, no, Mr. Chairman, I am not referring to my great-grandfather.

I am referring to Adam Smith, who said they would. The job Congress intended for the ICC is to provide a check to the incredible market power of the railroads.

Mr. Chairman, no one expected that the Interstate Commerce Commission would sit on its hands and do nothing to prevent the railroads from running roughshod over captive shippers. No one expected that the ICC would twist and confuse the regulatory framework to stack the deck against the shippers.

Finally, no one expected that the railroads would be able to load up on captive shippers and by their own admission generate all of their profits from this group of captive shippers—largely because the ICC has so totally ignored the fundamentals of the so-called Long-Cannon principles.

Mr. Chairman, as we go through these hearings, I will have more to say about the process employed by the Interstate Commerce Commission and the way in which my legislation would correct the problems attending this deregulatory framework.

Today we will look at the health of the railroad industry, a particularly intriguing subject. Two very different pictures emerge in this regard: the picture of the ICC, which they generate, with the revenue adequacy tests; and the picture generated by every other measure of financial soundness, including, I might say, common sense.

Mr. Chairman, revenue adequacy is the crucial linchpin in the case of a captive shipper. Once a railroad is found to be revenue inadequate by the ICC standards, the volumes of statistical studies and all the indicators of captivity get thrown out on the ICC's scrap heap of regulatory neglect.

Does the ICC process make any sense when on one day the administration is trying to sell them Conrail, the Norfolk Southern system can be acclaimed by the Secretary of Transportation as a very profitable business with deep pockets, and the next day it is considered one step away from the poorhouse?

Does the ICC standard make any sense when some of our Nation's railroads have the cash reserves to purchase trucking companies, barge companies, oil and gas companies, bank holding companies, and airlines?

Mr. Chairman, the coal producers in my State of West Virginia, as well as the grain producers in your State, want a healthy rail system. And most shippers everywhere do not want to return to the pre-Staggers Act era.

All of us expect, however, that the process will assure that all parties have a fair shake at the ICC.

I look forward to today's hearings, Mr. Chairman, and once again I congratulate you on your leadership.

Senator **Exon**. Thank you very much, Senator Rockefeller.

I will now recognize the ranking member of the Subcommittee, Senator Kasten.

OPENING STATEMENT BY SENATOR KASTEN

Senator **Kasten**. Mr. Chairman, thank you very much.

I want to congratulate you on the beginning of your comprehensive hearings on the current condition and functioning of our railroad freight system.

Today's hearing will focus on the economic condition of the rail industry. In the 1970s, we came perilously close to general bankruptcy of the major rail carriers. Failures by railroads, such as the Rock Island and the Milwaukee Road, created severe economic dislocation.

In 1980, the Congress was faced with a choice. Some wanted nationalization of the railroads. Others argued that increased competitive freedom was the better course.

Wisely, I believe, the Congress passed the Staggers Rail Act, which gave the railroads more flexibility in their pricing and service decisions.

There has been some debate over the Interstate Commerce Commission's implementation of the Staggers Act. That implementation will be covered in our hearing next week.

There was no disagreement, though, that the Staggers Act's increased freedoms have enabled the railroads to rebound. The railroads have upgraded their facilities and service, and this has benefitted many shippers and employees.

I look forward, Mr. Chairman, to the testimony of our witnesses from the railroad industry, from the financial community, and the Consumer Federation.

These witnesses should give us a good picture of the present condition and the future prospects of the rail industry, and I look forward to working with you as Chairman of this Subcommittee on these very important problems.

Senator **Exon**. Thank you very much.

Senator Danforth, do you have a statement?

OPENING STATEMENT BY SENATOR DANFORTH

Senator **Danforth**. Thank you, Mr. Chairman. I want to commend the Chairman for arranging this comprehensive examination of the current condition of our railroad industry.

To evaluate the railroad industry's current condition, it is important to recall its condition in the late 1970's. The railroad industry's return on investment was under 2 percent and 22 percent of the railroad system was in bankruptcy. Railroad service was frequently unreliable and generally unresponsive to market demands.

Some in Congress wanted to nationalize the railroads. Instead, Congress recognized that many of the railroads' problems were the result of over-regulation by the Interstate Commerce Commission, and reduced this regulation with the Staggers Rail Act of 1980. Since the passage of the Staggers Act, this Subcommittee has conducted numerous hearings on the condition of the rail industry. What we have found is that the railroads have used the Act's increased freedoms to improve their financial health and upgrade their service, equipment, and track to the benefit of shippers, communities, and employees.

One of the most encouraging developments since the passage of Staggers is the emergence of a new breed of regional and short line railroads. Risk-taking entrepreneurs have formed well over one hundred small railroads since 1980. These new railroads have given the rail industry a much needed shot in the arm. I look forward to the Subcommittee's examination of how the Congress can assist the growth of small railroads.

Senator EXON. Thank you, Senator Danforth.

I have a statement from Senator Pressler that he would like to have inserted in the record.

We will now call our first panel: Mr. William Dempsey, President of the Association of American Railroads, who is accompanied today by Richard Briggs, the Executive Vice President of the Association of American Railroads; and Mr. David J. Hughes, the Executive Vice President, Bangor and Aroonstook Railroad Company, on behalf of the Regional Railroads of America.

Mr. Dempsey, would you proceed, please.

STATEMENT OF WILLIAM H. DEMPSEY, PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS, ACCOMPANIED BY RICHARD E. BRIGGS, EXECUTIVE VICE PRESIDENT; AND J. THOMAS TIDD, VICE PRESIDENT—LAW

Mr. DEMPSEY. Thank you very much, Mr. Chairman.

I want to express our appreciation for your holding this hearing.

As you indicate, there are a number of legislative proposals that would impact the railroads in different ways, and, as you indicate, they should be judged in a major way against the background of the economic condition of the industry.

I begin with my conclusion, which is that the economic condition of the industry is very fragile and, indeed, troubled; that the future is dim; and that, accordingly, any legislation that would reduce revenues in any significant way or increase costs in any significant way should, at the very minimum, be scrutinized extremely carefully and should be passed with only the most compelling justification. Indeed, you can understand it if I say that it should not be passed at all.

I have a series of charts, and because of time limitations, I will run through them swiftly. But I hope they may be helpful to the Subcommittee.

[Charts are shown.][1]

Mr. DEMPSEY. I won't spend any time on the 1970s. This first chart is just to indicate what the situation was immediately prior to enactment of Staggers.

We had the whole Northeast in bankruptcy. The Rock Island was wiped out; the Milwaukee Road was cut in half. We had 21 percent of the trackage under the gavel of the bankruptcy courts. It was a decade of economic chaos.

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[1] See p. 15.

Obviously one important reason was over-regulation, though it was not the only one.

Congress responded with the Staggers Act.

The data that I will give you now are data embracing the major kinds of economic indices for the industry for the Class I carriers.

I begin in 1980, because that is really the last post-Staggers year. Staggers went into effect on October 1, 1980.

The trends, the financial indicators are all negative at this point, and the fundamentals of the industry are weak, as I will indicate in a moment.

Beginning with net railway operating income, as you can see, we had $1.3 billion in 1980; we slipped into the recession; we came out in 1984, and we were all rather optimistic them. Then we slid, in 1985 and 1986, and now in 1986, we are 31 percent lower in real terms in net income than we were in 1980.

Senator EXON. Would you explain that index to me. Leave that chart up there for a moment.

I see you have net in billions. What does the index mean? Are you using 1980 as the base?

Mr. DEMPSEY. That is the base. That is the 100 base. We are down on that base to 69, or a diminution of 31 percent during that period of time.

That obviously then will show up in the standard forms of measurement of economic performance. Here is the most common one, return on equity. The railroads are shown in black; all industry is in the middle; and the utilities I identified because they are the principal proponents of the CURE legislation on the left. You can see how far short of American industry—and particularly the utilities—the railroads fall.

Return on investment is the methodology used by the Commission and by public utility commissions. This is the only chart as to which I think there might be some disagreement among the various parties contending. There are some rather arcane accounting questions involved in how you calculate the investment base.

Recently, the Commission has adjusted the investment base downwards by excluding deferred taxes, for example. So, doing that, those black lines would rise perhaps 2 to 3 percent—still far short of the cost of capital, which is the target. It is the target because, if over the long run a business does not earn the cost of capital, it is going to go out of business one way or the other. It is going to shrink or it is going to move into another line of commerce.

No matter what adjustments you make to these figures, on the issues in controversy the railroads never come close, as a group, to earning the cost of capital.

The disturbing thing is the trend, beyond the absolute figures, because, as you see, we are slightly worse off in 1986 than we were when we started, in 1980. And that is no matter how you adjust those figures.

Why is that?

Demand is off. Our business is off. Our car loadings are off an average of 13 percent. We have 18 commodity groups, and you can see the industries we serve. You can understand what has happened. There are iron ore, iron and steel, grain, grain products, lumber. In 13 commodity groups, we are off from 50 percent to 12 percent.

We serve smokestack America and we suffer when they suffer. They are suffering now and so are we.

We all know what is happening in terms of a change from the focus of the economy, from durable goods to service industries, and we serve the durable goods, the manufacturing component of the industry. We all know the reasons for that—diminishing exports, increasing imports, and all of that.

We also, on the rate side, have had enormously increased competition from the trucks because mainly of truck deregulation, but also because of increased weights and sizes permitted by the Congress.

The barge industry has had a dramatic surplus in equipment during this period of time, and so the rate competition has been enormous. Accordingly, we have also had severe rate compression due to barge competition.

I can give you the figures as to rates. I am giving you the absolute figures, now, not adjusted for inflation.

In general, our rates have gone up during this period 8.3 percent; on coal, 6.3 percent; utilities, by contrast, went up 21.3 percent.

In constant dollars, our rates, on average, went down 5.1 percent; coal went down 6.9 percent; and grain went down 44 percent.

So our rates have gone down because demand has gone down and because of increased competition.

This next chart shows in a different way what the result has been (indicating). Our revenue per ton mile is flat. That is to say, we are about where we were in 1980 in absolute terms. It is sharply down in real dollar terms in revenue per ton mile.

If all of that has happened, then how have we stayed afloat? There is only one answer to that. It is not on the revenue side, as I have indicated. It is all on the cost side.

We are constrained by competition. That is what has happened to our rates. They have gone down.

We have had to respond by dramatic cost curtailments. That has come in a variety of different ways—increased efficiency and utilization of our equipment, improved equipment—and all of that is set forth in detail in the prospectus to my statement.

The principal problem here has been labor costs. Our labor costs represent 47 cents out of every dollar of revenue.

Our labor costs are much, much higher than in the rest of American industry, and much higher than our competitors'. Our average compensation, including fringes, is $46,000 a year. This is 87 percent higher than the average compensation in the United States. It is something in the way of 46 percent higher than the average compensation in the manufacturing industries, and it is substantially higher than trucking labor costs.

Failing any wage rollbacks during this period of time, the managers did the only thing they could, they reduced employment by some 43 percent during this period of time. We lost about 200,000 employees.

If that had not been done, our wage costs would have been in 1986 $7 billion more than they were; that is to say about six times our net operating income. And obviously the whole industry would have been in bankruptcy.

This is the only way that the industry has been able to respond. It is probably the only way that it will be able to respond in the future. This is to say, increased productivity, and cost curtailments.

There are great opportunities here. I do not mean to paint an altogether bleak picture. We have great opportunities in research and test and development in terms of equipment and equipment utilization, and a host of technological improvements that will help us, and that we look to for help.

That, in short, is the economic picture of the industry. It is not a happy one, I am sorry to say.

Without the Staggers Act we would have been in much worse shape. So I do not mean to diminish in any way the importance of that Act. But the Staggers Act, by itself, could not do the job of raising revenues in the industry to an adequate level.

Wall Street knows what is going on. This chart indicates what has happened to stock indices during this period of time: rails up 27 percent; utilities up 114 percent; Dow Jones Industrials up 97 percent.

It is no secret to anybody who is studying the figures as to what has been happening to the rail industry.

There are, as I say, legislative proposals. You are going to hold hearings on CURE and I will not speak to that bill except to note that it seems to us clearly designed to——

Senator EXON. It would be perfectly all right if you wish to address it. I would imagine that it is going to come up a time or two.

Mr. DEMPSEY. It may come up, but I think I will wait until it does. It seems designed, however, to decrease revenues and to increase costs, and the industry really cannot tolerate that financially.

The other issues are mainly labor issues, and they go to our core issue of labor costs.

We face, for example, a daunting problem on railroad retirement. Our Railroad Retirement Fund is, again, in deep trouble. We are running a deficit of about $300 million a year or more, on a pay-as-you-go basis.

If we were to fund that liability by ERISA standards, it would cost the industry about $1.5 billion a year, that is to say about the same as our net operating revenue.

So, if that burden were thrust on the industry, the industry just cannot survive in its present form.

It is such a serious problem that I respectfully suggest that no legislative action that would be harmful to the railroads should be taken until that problem is solved in a way that makes it possible for the industry to continue as a viable private enterprise.

We have other labor issues that are terribly important. One Mr. Hughes may speak of—I'm sure he will—and that is the question of the imposition of labor protection upon line sales to railroads, the question of whether labor protection should be imposed. If it is imposed, those sales will largely end. Those lines will close down, and the railroads will lose the opportunity to maintain that business in an efficient way.

My time has expired, Mr. Chairman. I appreciate it.

Thank you.

[The statement and questions and answers follow:]

STATEMENT OF WILLIAM H. DEMPSEY, PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to present the views of the Association of American Railroads on the state of the railroad industry. I am submitting with this statement our recently completed report on the economic outlook for the industry entitled "America's Railroads After Staggers: An Economic Prospectus." In this prepared testimony, which is submitted for the record, I shall summarize that report and then discuss briefly the legislative considerations which will determine whether the railroad industry is to become and remain viable in the private sector of our economy. For my oral presentation, I shall use several charts. Copies of those have been provided to the Subcommittee.

The message I want to leave with the Subcommittee today is this: The railroad industry is in trouble and it sorely needs the help of the Congress. That help must come by way of forbearance as well as by action—action to reduce existing statutory burdens unique to the railroad industry and forbearance in increasing those burdens for the benefit of others. The railroads can survive in the private sector only under a federal statutory environment in which the railroads are treated like other industries operating in the private sector—no better nor no worse—and the long-run economic costs of the intercity freight transportation provided by each mode are attributed to each and borne, ultimately, by the shippers who purchase that transportation. The Staggers Act was a start, but just a start—the overburden of regulation being only the most obvious of the statutory handicaps under which the railroad industry was and is operating. After summarizing the economic state of the industry, I will discuss these statutory handicaps in more detail.

THE STATE OF THE RAILROAD INDUSTRY

While the industry has successfully arrested the decline of the 1970's, and managed to weather the serious recession of 1982, its resiliency must not be overstated. America's freight railroads still face deep-seated problems. The profitability of the industry has been steadily declining; when adjusted for inflation, railroad operating earnings have dropped nearly one-third between 1980 and 1986. The industry remains unable to earn its current cost of capital. In fact, railroad return on investment in 1986 was actually lower than the level recorded for 1980 when Congress authorized a partial deregulation of the industry.

The collapse of the industry was avoided during the early 1980's because federal policies finally gave railroad managers the tools to cope with an increasingly difficult business environment. The Staggers Act of 1980 increased the permissible range of action managers could take to improve revenues and reduce costs. The Economic Recovery Tax Act of 1981 materially enhanced cash flows. And the railroads have aggressively sought to improve productivity and remain competitive.

Some of those tools are gone; indeed, the new tax structure creates great uncertainties for capital-intensive, cyclical industries such as the railroads and many of their most important customers. Yet the business environment continues to pose challenges on all sides. Much of the railroads' traditional base—steel, heavy manufacturing—has substantially eroded in the face of foreign competition and reduced demands. American exports of coal and grain have similarly been hard hit, with a resulting decrease in rail served movements. The increased consumption of imported commodities leads to an overall decrease in the requirement for transportation because of the loss of the raw material movements that underlie the production of the displaced domestic commodities.

The dynamics of the transportation market make it increasingly difficult for railroads to maintain healthy competition with trucks and barges. Changes in logistics, such as just-in-time inventory, favor the flexibility of service that trucks can offer. Downsizing of products and product substitution have also reduced the call for rail service. Substantial breakthroughs in truck productivity, many enhanced by government, exert strong downward pressure on railroad pricing. Proposals to increase truck sizes and weights—such as those embodied in the so-called "pin-wheel" amendment—could require the railroads to lower their rates to a level where they would lose some 65 percent of their pre-tax net operating revenues. Similar pressures obtain on barge-competitive traffic as a result of a chronic and persistent overcapacity of barge equipment.

Facing little or no growth in their traditional customer and stiff intermodal competition, railroads can anticipate no major relief on the revenue side. Rate compression will characterize the industry for the foreseeable future. If railroads are to continue to serve the economy as healthy enterprises, therefore, they must take dramatic steps to reduce costs and must invest heavily in new technology to improve productivity.

Thus far they have been able to respond. A significant trend toward the development of total transportation companies is emerging. Plant and equipment capacity has been tailored to new needs. The industry is actively working on new technology promoting efficiency. Quality service and its companion, safety of operations, have shown dramatic improvements. Yet much more will need to be done if the railroad industry is to become and remain viable. It obviously cannot absorb additional economic handicaps such as those contained in some of the legislative proposals pending before the Congress. To the contrary, the Congress must revise a wide range of federal policies that have lost their relevance in today's social and economic environment and severely disadvantage the railroads in the competitive struggle.

If, instead, the Congress imposes an even more hostile governmental environment, railroad managers would have few choices; some indeed would have none. Access to the capital markets would essentially be denied and internally generated cash would be the exclusive source for maintaining the physical integrity of the system. Faced with a similar dilemma, railroad managers in the late 1960's and 1970's, handicapped by federal policy in cutting costs, resorted to across-the-board rate increases. Because railroads had long lost their market strength against other modes, this course led to massive diversions of traffic which further aggravated the cash shortfall. For many companies this ultimately meant deferred maintenance, for some, bankruptcy or liquidation. Shippers received poorer service at higher cost. To avoid repeating that scenario in the 1990's, those railroads that could, would shrink to truncated core systems, operating mileage well below anything presently contemplated. Many communities and shippers would be deprived of rail transportation. If even that avenue of relief were denied by law, the economic viability of the industry in the private sector would be ended.

There is an alternative to the downward spiral of the railroad industry; it is to balance the legislative scales to permit the industry to meet its challenges and to contribute to the nation's economic well being.

SOME OF THE ISSUES TO BE CONFRONTED IN MOVING TOWARD NON-DISCRIMINATORY TREATMENT OF RAILROADS

Averting More Regulation.—Because this hearing is concerned with an overview of the railroad industry, I will reserve for a later hearing any discussion of the various provisions of the so-called "C.U.R.E." bill now pending before the Subcommittee (S. 676). I would simply note that if efforts such as C.U.R.E.'s to return the railroad industry to the pre-Staggers era of regulation are successful the industry's demise is assured.

The C.U.R.E. bill is not the only pro-regulation proposal confronting the railroads. S. 443 would amend the Clayton Act to repeal the protection from treble damages under the antitrust laws which railroad rates filed with the ICC now enjoy pursuant to a longstanding judicial doctrine. The bill would also remove the protection against private injunctive actions against railroads which section 16 of the Clayton Act now provides all common carriers with respect to any matter subject to regulation by the Interstate Commerce Commission. It is to be noted that in each instance the repeal would apply only to railroads not, as the case may be, to all other regulated industries or all other common carriers regulated by the ICC. Thus, the bill not only creates a dual regulatory system by overlaying the Interstate Commerce Act with the antitrust laws as to the same matters but, by singling out the railroads, does so in a patently discriminatory matter.

DEALING WITH THE SOLVENCY OF THE RAILROAD RETIREMENT ACT

The railroads are now contributing 21.9% of taxable payroll to the Railroad Retirement Fund. Railroad employees are contributing 11.4% of taxable payroll to the Fund. 7.15% of the contribution of each funds the railroad equivalent of social security, the so-called "tier 1." The balance of the contribution of each funds the private-pension portion, the so-called "tier 2." Despite this large contribution—a total of 33.3% of taxable payroll—the Fund is facing insolvency and a further tax increase of 3% of taxable payroll has been proposed by the Fund's actuary and included in the President's budget. The current indications are that even that increase will be insufficient to restore solvency.

The underlying problem is the continuing decline in the railroad work force—the ratio of workers to retirees now being 1 to 3. That decline is attributable to the factors mentioned earlier—a decline in the traditional sources of rail traffic such as heavy industry and mining and strong competition from motor and water carriers for traffic from all sources. The pressures which these forces place on the railroads to reduce costs are inexorable and, with employee costs consuming 47¢ out of every dollar in revenue, reducing those costs becomes imperative to the railroads' survival.

The present and proposed taxes are those required to sustain the Railroad Retirement Fund on a pay-as-you-go basis. Were the system to be "privatized" as proposed by the Administration and more stringent funding requirements applied, the additional funds required could quadruple.

Achieving solvency on either a pay-as-you-go or funded basis is going to require careful study and include consideration of benefit levels as well as taxes. With net income for the entire railroad industry in only the $2 billion range (excluding the effects of write-downs) and the resultant returns on equity in only the 7% range, it is clear beyond any doubt that a successful solution cannot be achieved simply by increasing the railroads' contribution to the Fund without immediately threatening the solvency of many railroads.

REPEAL OF THE FEDERAL EMPLOYERS LIABILITY ACT

Unlike the rest of the U.S. labor force, on-the-job injuries and illnesses of railroad workers are dealt with under an adversarial fault-based system rather than a no-fault workers' compensation system. Despite its good intentions when it was enacted at the turn of the century, the Federal Employer's Liability Act (FELA) serves neither the interests of the railroads nor injured rail workers. Further, it is out of step with public policy regarding compensation for workplace injuries. It is time to consider a change to a system that is more humane, more efficient, and more in tune with enlightened labor-management relations.

The problems engendered by the FELA are numerous and substantial:

1. A fault-based system such as the FELA runs counter to society's goals of compensating injured workers regardless of fault and results in excessive awards in many cases and inadequate awards in others.
2. A disproportionate share of the costs under FELA are incurred in the form of administrative expenses and legal fees rather than benefits for injured employees.
3. The FELA creates a disincentive for employees to participate in rehabilitation programs and an incentive to maximize lost earnings and medical expenses in order to maximize the recovery of damages.
4. The need to prove fault for on-the-job injuries results in divisiveness between labor and management and tends to obscure the real causes of accidents and injuries in the workplace.
5. There is no rational reason for continuing to treat the railroad industry in a manner apart from virtually every other industry in the United States with respect to the compensation of employees for on-the-job injuries.

The claims payout under the FELA in 1979 was bout $296 million. The estimated claims payout in 1986 is $585 million. In that same period, the number of railroad employees declined from about 502,000 to about 302,000. So, in a period when employee exposure declined by about 40%, the claims payout increased about 97%. In the same period, the railroads overall safety record steadily improved. Thus, the increase in claims payout cannot be explained either by greater exposure or by greater risk. It can only be explained by infirmities inherent in the tort system which the FELA imposes upon the industry. Except by its incorporation in the Jones Act (applicable to seamen), it is not a system imposed by Congress on any other industry and its repeal is long overdue.

IMPAIRING LINE SALES WITH LABOR PROTECTION

In a national labor force of 118 million people, the only ones who have been guaranteed job protection by federal statute are some 300,000 railroad workers. In most transactions affecting employment (consolidations, mergers, trackage rights, acquisitions of control, line extensions, "feeder line" sales, and abandonments) railroad employees whose jobs are affected are guaranteed 100% of pay, subject to wage increases, for a period equal to their length of service up to a maximum of 6 years. The costs of such protection to the railroad industry are enormous. The amount paid in 1985 by just seven railroads, including severence payments made to buy out of protective obligations, was approximately $338 million.

No case has been made that, as a practical matter, the problems of rail labor are unique in the American work force. During the past several years, mergers, consolidations and plant closures in many industries have resulted in labor retrenchments at least as severe as any experienced by rail labor, but none of the displaced employees received salary continuation for six years pursuant to federal law.

But rather than paring back rail labor protection to a level commensurate with that existing in other industries, a legislative effort is underway to extend the existing protection to line acquisition cases in which the Interstate Commerce Commission is now authorized to impose protective conditions but not required to do so.

The issue arises because, during the past three years, several railroads have implemented policies of selling, rather than ultimately abandoning, marginal rail lines where such lines can be operated successfully by a short line or regional railroad company. In so doing, these railroads are pursuing the national goal enunciated in the Staggers Act of developing a rail system that can remain viable in the private sector. Because local and regional railroads can offer a lower cost service and are in close touch with the shippers they serve, these sales have benefited shippers and online communities by preserving and improving their rail service. They also have benefited the national railroad system by feeding traffic from light density lines to the mainline system on an economically rational basis.

In reviewing such sales the Commission concluded that the public interest in preserving rail service for shippers and communities and enhancing the viability of the national railroad system by keeping traffic from marginal lines in the railroad traffic base, outweighs the interest of railroad labor in having labor protective conditions imposed. This policy recognizes that the imposition of labor protective conditions on line sales could seriously jeopardize the economics of continued rail operations and result in abandonment of the property with the attendant loss of both service and jobs on the line.

The need for economic rationalization of the railroad system in the United States is a pressing one.[1] The opportunity for the creation of numerous, low cost, efficient regional and short line carriers which can continue lines in service should not be foregone by imposing the costs of labor protection on the carriers involved. The nation as a whole will be the loser for that.

The far more substantial labor protection issue to be addressed by the Congress is why federal law continues to impose an extraordinary protection burden on an industry that is now smaller than some individual corporations and one facing a serious challenge for survival.

ELIMINATING SECONDARY BOYCOTTS

Finding that the Railway Labor Act does not forbid such activity, the Supreme Court has recently upheld the right of railway labor to engage in secondary picketing. Since 1947, the use of secondary economic weapons has been prohibited in other industries by the National Labor Relations Act. There is no legitimate basis for distinguishing the railroad industry with respect to such labor activity. Unrestricted secondary activity, as permitted by the recent decision, will substantially increaase the disruption to interstate commerce in railroad labor disputes, with harm to neutral employees, shippers, consumers, and the general public.

The recent dispute between the Brotherhood of Maintenance of Way Employees and the Maine Central Railroad demonstrates the threat to the nation's commerce and the Railway Labor Act's procedures of unrestricted secondary activity in railroad labor disputes. The BMWE-MEC dispute involved only approximately 100 employees in northern New England, yet the BMWE picketed and disrupted major carriers as far away as Los Angeles. Ironically, the BMWE picketed and struck the major rail carriers while those carriers were engaged in national collective bargaining negotiations with the BMWE, and the Railway Labor Act's status quo obligation prohibited self-help by the union in the national bargaining dispute. The BMWE precipitated a national emergency requiring the appointment of a Presidential Emergency Board only by extending the MEC work stoppage to other neutral carriers such as Conrail.

In the absence of legislation prohibiting secondary activities rail unions will be able, in countless future local disputes, to use secondary job actions to create or threaten to create national emergencies requiring the intervention of emergency boards, and potentially, the Congress to legislate collective bargaining settlements. Again, the Congress should ask why an action that is explicitly denied to 118,000,000 other workers in this country continues to be available to 300,000 railroad workers.

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[1] It is estimated that elimination of 30,000 miles of line, or 19 percent of the network, could be accomplished with a lost of less than 4 percent in carloadings.

ASSURING THAT SAFETY REGULATIONS DO NOT EXTEND BEYOND SAFETY CONCERNS

There has been since 1980 a dramatic and continuous improvement in railroad safety, the number of accidents declining from 8,451 in 1980 to 3,430 in 1985. In addition to the strong human concern for the welfare of its employees, a railroad has an obvious economic interest in safety. Even where there is no injury to an employee, accidents cost money in terms of damaged property, damaged freight, delays, and loss of goodwill.

But we do not live in a risk-free society, nor could we afford the cost of attempting to do so. Just as ignoring safety results in needless costs, so does an excess of safety regulation. At the margin, the cost of a particular increment of safety may not be worth the benefit. It is for this reason that new proposed safety regulations deserve the most serious scrutiny by the Congress, rail management and rail labor.

At the other end of the safety regulation spectrum are essentially economic proposals being offered in safety garb. Such proposals are appropriately addressed at the bargaining table. The railroad industry cannot afford safety regulation which has, as a principal objective, not safety regulation which has, as a principal objective, not safety but the creation or maintenance of jobs.

FINANCING THE TRANSPORTATION INFRASTRUCTURE

Rail competitive trucks receive a subsidy from both federal and state governments in the form of user charges set too low to cover the heavy truck share of highway costs. The 1982 Federal Highway Cost Allocation Study (HCAS), updated for 1985, found that heavy trucks of 75,000 pounds gross vehicle weight or more paid only 65 percent of their cost responsibility. State studies have found comparable underpayments.

Rail competitive trucks almost certainly pay less, since the 65 percent refers to the average 75,000 pound truck and rail competitive trucks travel at higher loaded weights and have much higher annual mileages. Using a methodology based on that of the 1982 HCAS, the AAR estimates that rail competitive heavy trucks pay only about 50 percent of their cost responsibility.

Total highway spending in 1985 was $56.9 billion. It is difficult to say what share of that amount is properly attributable to heavy trucks. However, for federal spending alone, the 1985 update to the 1982 federal HCAS update indicates that trucks 75,000 pounds and above paid $1,206.6 million in highway taxes. Applying the average 65 percent payment figure means they owned $1,845.0 million, leaving a gap of $638.4 million. That "gap" is reflected in lower truck rates and places the railroads—which must pay all of their own right-of-way costs—at a serious competitive disadvantage.

A signficiant amount of rail traffic is also competitive with the barge industry. Waterway users receive an even larger percentage subsidy than heavy trucks. The Army Corps of Engineers spends annually about $575 million on shallow draft navigation—more than ten times the barge industry user charge payment of about $50 million.

The ten year, phased-in increase in barge user charges passed last year will make only a small difference. Even by 1995, when the barge user charge is fully phased-in, the barge industry will be covering no more than 15 percent of federal spending on its behalf.

Assuming that the total of these annual subsidies to motor and water carriers are fully reflected in reduced rates, the competitive effect on rail rates is to reduce rail revenues by more than $1 billion annually. Where a competitor's costs are lower due to efficiency the railroads cannot complain; however, there is strong ground for complaint where those costs are not lowered by efficiency but rather by shifting the burden of the costs of competing carriers (and ultimately their shippers) to other highway users or the general public, as the case may be.

CONCLUSION

In each of the foregoing examples, the railroad industry is being subjected to unnecessary costs or put at a cost disadvantage in the marketplace. Some of the laws involved made sense in their day—a time when the railroad industry was the nation's largest single employer—but that day has long since passed. If the Congress is to stay the course it set in the Staggers Act—"to assist the rail system to remain viable in the private sector of the economy"—it has to remove the statutory obstructions which lie in that course and avoid erecting any others.

RAILROADS FILING FOR BANKRUPTCY, 1970–79

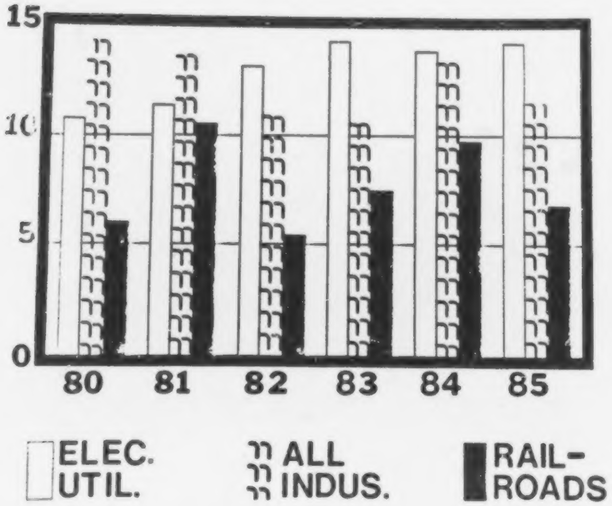
Railroad	Route miles	Percent United States total
Ann Arbor	299	0.1
Boston & Maine	1,527	.7
Central Railroad of New Jersey	592	.3
Chicago, Milwaukee, St. Paul and Pacific	10,079	4.8
Chicago, Rock Island & Pacific	7,361	3.5
Erie-Lackawanna	2,866	1.3
Lehigh Valley	927	.4
Penn Central	20,238	9.6
Reading	1,205	.5
Total	45,094	21.2

DECLINE IN RAILROAD PROFITABILITY—NET RAILWAY OPERATING INCOME (ADJUSTED FOR INFLATION)

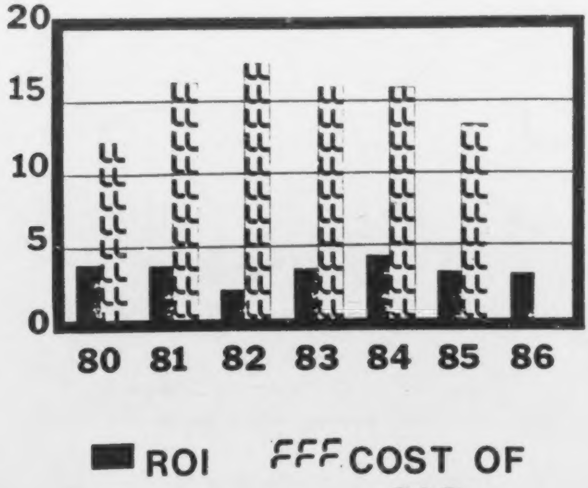
	1980	1981	1982	1983	1984	1985	1986
NROI (billions)[1]	$1.3	$1.2	$0.6	$1.1	$1.3	$1.0	$0.9
Index	100	92	46	85	100	77	69

[1] (Exclusive of interest, fixed and special charges.)

RETURN ON EQUITY

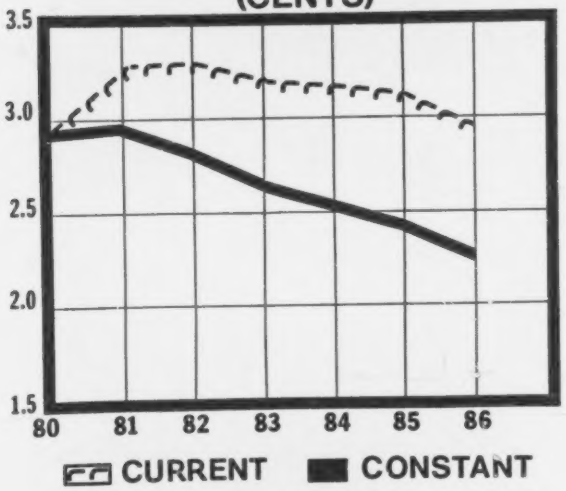


RETURN ON INVESTMENT VS. COST OF CAPITAL



REVENUE PER TON-MILE HAS DECLINED

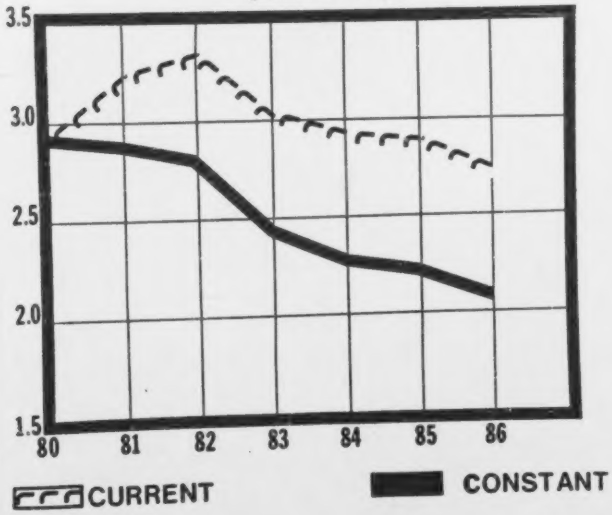
(CENTS)



RAIL SHARE OF INTERCITY FREIGHT
REVENUE: 1980 = 20.4%
1985 = 16.6%

EXPENSES PER TON-MILE HAVE DECLINED

(CENTS)



Decline in demand—rail carloadings, 1986 versus 1980

Railroad:	*Percent decrease*
Iron ore	−50
Iron and steel	−50
Phosphates	−41
Food products	−39
Grain mill products	−38
Pulp and paper	−38
Stone clay and glass	−36
Waste and scrap	−35
Coking coal	−21
Petroleum products	−20
Grain	−20
Lumber	−15
Chemicals	−12

RESULT OF DECLINING DEMAND AND INCREASED COMPETITION

Rail rates in constant terms have declined since 1980.

Rail rates in current terms have declined every year since 1982.

Percent changes in stock indices years' end, 1980 versus 1986

	Percent
S&P electric utilities	114
DJ transmission	103
DJ industrial	97
DJ utilities	80
S&P 500	78
S&P transmission	56
S&P railroad	27

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS

Question 1. The industry has attributed many of its investments in improving track and related structures to benefits derived from the Staggers Act. Isn't it true that the tax laws and certain tax credits also played a significant role in these investments? Elaborate on the impact you feel changes in the tax laws may have on the industry.

Answer. During the 1981–86 period, Federal tax laws had a very significant and most positive impact on the improved cash flow of the railroads. As pointed out at page 2 of my formal testimony before this Committee on June 9, 1987, the Economic Recovery Tax Act in 1981 materially enhanced cash flows. Among other things, that legislation required a change in the railroads' method of tax accounting for track expenditures. While prescribing longer recovery periods for money future track outlays, it did permit a one-time recovery of past track expenditures which had not been depreciated. We estimate that one-time recovery of the so-called frozen base produced an estimated $2.5 billion in added cash through 1985. See pages 11 and 12 of the study appended to my June 9th testimony.

Similarly, the continuation of the investment tax credit produced almost as many savings during this period. And ACRS depreciation also was beneficial.

The principal benefits of the frozen base ended in 1985. Investment tax credits and ACRS were terminated last year so all of these sources of improved cash flow are now lost. Under the 1986 Tax Reform Act, we have estimated that railroads' Federal income taxes for 1986–1991 will be $2.5 billion more than under the rules existing prior to its passage if earnings remain constant. If rail earnings decline, the losses will be even more severe. Those huge projected cash drains stem from the elimination of the investment tax credit, less generous depreciation and a tougher alternative minimum tax—which overwhelm the gains made from lower corporate rates.

Moreover, those figures do not reflect the real possibility that production by some of the railroads' capital intensive shippers (steel, mining and heavy machinery) will decline due to the harsher, new tax rules nor do they consider the stronger competitive positions of trucks and barges which, because of their less capital intensive nature, were less disadvantaged under the new tax laws.

On balance, the former tax laws and the Staggers Act were, as we have stated previously, both major contributors to the ability of the industry to reinvest in rail plant during the past six years. Having now lost most of those positive tax features, the railroads can ill afford to see the benefits of Staggers significantly reversed.

Question 2. The rail industry has expressed concerns about what it characterizes as high labor-related costs. Do you have comparison of these costs with those borne by your primary competitors, the truck and barge industries?

Answer. The average annual cost for a railroad worker is about $46,000 including fringe benefits. For our principal competitors, the motor carriers, the comparable figure is $34,000. For the barge industry, which is as heavily unionized as the rail industry, the comparable figure is $47,000.

Just as important as compensation levels—indeed, more important—are the many and serious restrictions on the productivity of rail employees. Work rules that have been overtaken by technology, for example, such as requirements for an excessive number of train crew members and rigid craft lines barring qualified employees from performing work other than that "belonging" to their particular craft. And labor protection either imposed by federal law—six-year full compensation guarantees in connection with railroad restructuring—or agreed to by railroads in order to secure the benefits of technological advances. The result is that, despite a 41% reduction in Class I employment since 1980, there remains a very substantial excess of employees receiving that average annual $46,000 in wages and benefits.

Question 3. You have testified that labor protection costs the rail industry approximately $338 million in 1985. Do you feel this was a respresentative year or might not these costs be declining as the industry completes the readjustments facilitated by the Staggers Act?

Answer. The figure for 1985 was based on a special survey of rail members and comparable data for other years is not available. If one assumes a decline in the number and extent of future restructuring actions, it would be correct to assume that these costs will decline as previous restructuring actions reach the six-year payout period. But that assumption may not be correct, and almost certainly will not be correct if the C.U.R.E. bill is enacted. The result of that bill, as I have testified, would almost surely be (1) an effort on the part of the railroads to shrink the rail plant as rapidly as possible in an effort to eliminate relatively low density lines, and (2) an effort to create further efficiencies by more consolidations.

QUESTIONS OF SENATOR ROCKEFELLER AND THE ANSWERS

Question 1. Please answer what seems to be a fundamental problem with the railroad business. You have testified that the railroads' traffic base is shrinking and you face very stiff competition from trucks. You also state that nearly all of the railroads' freight—80-90 percent—is competitive. It seems that much of the industry's problem is competition, not regulation. You also testified that your fastest growing segment of traffic, piggyback, pays only about 112 percent of variable cost, on average. Coal, by contrast, is a plentiful domestic resource with a large, still untapped world market, and foreign coal buyers are unanimous in their opinion that excessive rail rates are the single most important factor frustrating the marketability of American coal. So, on the one hand, the railroads are providing extremely low rates in a shrinking traffic base to increased pigback market share, while leaving a profitably hauled commodity in the ground. Why does either of these marketing tactics make sense?

Answer. I cannot agree with the basic premise of the question, namely, "that excessive rail rates are the single most important factor frustrating the marketability of American coal." The Energy Information Administration of the Department of Energy provided some comparative data on mine and rail and port costs of coal in its report entitled "Annual Prospects for World Coal Trade 1985." For deep mine coal from Appalachia and Australia the report shows mining costs of $22 for the latter and, for the former, mining costs of $33 ($26 if non-union labor used). The rail and port costs for the Australian coal were $15, for the Appalachian coal they were $16. In other words, an $11 difference in the price of coal but only a $1 difference in rail and port costs. The same report showed Canadian rail and port costs of $16 to $18—further evidence that U.S. rail costs were not out of line.

It is generally in a railroad's interest to haul all of the coal it can haul at profitable rates—and I use the term "profitable" to mean at rates making some contribution to fixed costs—taking into account all of the competitive factors that may exist. Indeed, the data for 1984 show that about 20 percent of coal moved at revenue to variable cost percentages below 120, *i.e.* at rates comparable to the average for piggyback traffic. By the same token, it is in a railroad's interest to haul all of the piggyback traffic it can as long as that traffic covers its own costs and makes a contribution to fixed costs.

The fact is that the supply of coal far exceeds the demand for coal and, in the world market, U.S. coal is at a severe price disadvantage before it leaves the mine mouth. The railroads are no more able than the coal mines to absorb the price reductions which would be necessary to overcome that disadvantage.

Question 2. You have testified that only by cutting costs have the railroads stayed afloat. Haven't much of these cost reductions taken the form of shifting costs to shippers? Can you provide us with the number of shipper-owned railroad cars? Shipper-owned locomotives? Does the AAR have any estimate on how much money shippers have spent on upgrade loading or switching facilities?

Answer. When costs of transportation are shifted to the shipper through the shipper's decision to buy its own cars, the rate charged by the railroad is generally decreased by an appropriate amount. Indeed, it is commonplace for tariffs to specify two rates, the rate charged depending upon whether the shipper or the railroad supplies the cars. The electric utility spokesmen have made much of the fact that they often buy their own cars. What they do not say is that the cost of those cars goes into their rate bases as an asset and the cost of the investment as well as the return on the investment is borne by their rate-payers and they receive lower rail rates to boot.

As of July 1, 1987, there were 1,297,919 freight cars in the national fleet of which 429,509 were owned by shippers. Of those 429,509, only 50,497 were coal cars. The AAR does not have data on shipper-owned locomotives but the number would be very small since their use would be limited to in-plant switching.

Neither does the AAR have any estimate of shipper expenditures to upgrade loading or switching facilities. The question, however, raises a point worth noting. A shipper would not invest money to upgrade a rail loading faciity unless it believed it could, through the sale of its product, recoup the cost of the upgrade including a market return on the capital invested. And there is no reason why a railroad should be expected to do so. If this nation expects to maintain a railroad system, those who use that system have to pay the costs of the system whether they do so directly by their own capital investment or indirectly through rates which adequately compensate railroads for their capital investments.

Question 3. The railroad chief executives who appeard before the Subcommittee all testified that they have virtually no captive shippers. Do you agree?

Answer. In terms of economic forces, yes. But, as a legal matter, as pointed out at the hearing, "captivity" is a definitional problem and it was acknowledged that the ICC's notions of "captivity" were more liberal than the railroads' notions. There are shippers with fewer alternatives than others or with alternatives that are more costly and, as to those, the railroads exercise proportionately greater market power. But, overall, there are relatively few shippers who have no other reasonable means of market access than rail and whose rates are unconstrained by geographic or product competition, or potential competition. As Mr. McKinnon pointed out, the fact is that both the railroad and the shipper are captive to the markets they are competing in.

Question 4. You testified that the 1986 Tax Reform Act will be harmful to the railroads. Doesn't that Act contain a windfall to help ease some of that harm? Railroads have accumulated large deferred tax reserves calculated at the old statutory rates, but will be required to repay those reserves at the new, lower rates. Therefore, there would appear to be a significant windfall in the transition to the new tax law. Please confirm if this is true and provide an estimate of the amount of the savings to the industry.

Answer. The 1986 Tax Reform Act contains numerous provisions affecting the level of future income taxes for railroad companies. Some of those are helpful, such as the lower rates you mentioned. Others are harmful. On balance, the Act appears to be a decided negative, the extent of which will depend on the level of rail profitability, the demand for rail services and the impact of tax changes on the railroads' competitors.

If rail earnings increase, the Act will be less punitive. On the other hand, if rail earnings continue to decline—as they have in the past two years, the railroads' tax liabilities will be much higher than they would have been under the old tax rules.

To be more specific, we estimated the impact of the 1986 Act on the railroad industry over the six-year period 1986-1991 with the assistance of Price Waterhouse & Co. Those calculations used a static level of demand for rail business and no change in earnings. Under that scenario, the industry's total Federal taxes will increase by $2.5 billion compared with taxes under the prior system. This increase occurs because the decrease in taxes due to lower rates ($2 billion) is completely overshadowed by a $3.1 billion loss due to the elimination of the investment tax credit, a $900 million loss due to longer depreciation and a $500 million increase due to the minimum tax provisions.

Lower earnings over the next six years will generate added taxes well in excess of the $2.5 billion as the benefits from lower rates decline and the impact of the minimum tax provisions escalate.

If earnings rise by 9 percent per year, the overall losses will diminish but the 1986 Act will still cost the industry $900 million more over six years than the tax rules it supplanted.

To compound the direct penalties of the Act, many rail customers are also capital intensive industries which will see their activities curtailed by the loss of the investment tax credit and less generous depreciation.

Finally, the Act treats rail competitors such as trucks and barges in a less damaging fashion. Being far less capital intensive since Federal and state governments provide the capital for their rights-of-way, these carriers will face significantly smaller new tax burdens than will the railroads.

In effect, the Act is a triple whammy for the railroads—it reduces the demand for rail services by key rail shippers, it reduces the relative costs of the railroads' competitors, and it increases the taxes on what profits the railroads manage to retain.

Question 5. When you say that the railroad industry is disinvesting out of the railroad business, you imply that this is not a positive development. Have the railroads made inadequate capital improvements in their physical rail structures since the Staggers Act? If so, how much more should the industry have invested in the rail business since 1980? Is the railroad physical plant, or a part of it, deteriorating today due to inadequate capital improvements? Is the railroad physical plant, or a part of it, unsafe?

Answer. Railroads have been disinvesting in recent years by retiring and selling assets which have not provided, and do not give promise of providing, an adequate return on investment. Disinvestment is not a positive development because it is a clear sign of inadequate earnings, and if earnings do not improve, the trend could continue to the point where the "critical mass" of railroad service is threatened. This is not to say that the disinvestment does not have positive components, for in fact, it has at least two positive elements. First, uneconomical assets have been disposed of, thereby making railroads more efficient and potentially more effective in competing for traffic, and (2) opportunities have been provided to local and regional railroads which, with lower labor costs and other advantages, have maintained service which otherwise would have been lost.

The railroads have not made inadequate capital improvements since Staggers. The point is that they have made improvements only to those segments of the system where there is some hope of recovering the investment—and, as evidenced by the disinvestment which has occurred, those segments are shrinking in number.

The plant the railroads are retaining is not deteriorating due to inadequate capital improvements. This is due in large part to the fact that (1) economically marginal lines have been sold to lower cost operators and uneconomic lines have been abandoned, (2) capital requirements for equipment in the past six years have been lower than past or future levels because of equipment surpluses, declining business, and productivity gains, and (3) the now lost advantages of the old tax laws—particularly the write-off of the frozen base—covered a large part of the railroads' reduced capital needs in the past six years.

The rail plant is not unsafe. Federal safety regulations require that the plant be maintained to standards commensurate with the level of operation. Those standards are strictly observed. Where revenues from a line are insufficient to warrant maintaining track to the standards required for the highest level of operations, the operational level is reduced.

Question 6. It would also seem that investment in other businesses is also a result of the shrinkage in the railroad business that has taken place. How many jobs has the industry eliminated since 1980, and what percentage of the workforce was that? How many miles of track has the industry abandoned since 1980, and what percentage of the track was that? How many miles of track has the industry sold to shortlines or non-major railroads since 1980, and what percentage of the track was that?

Answer. The U.S. freight railroads have undergone a significant restructuring in recent years due to increasingly strong intermodal freight competition within an economy which has become progressively more service-oriented (as opposed to production-based). Plant, rolling stock, and employment levels are being rationalized in an effort to improve economic efficiency and productivity.

The reduction in railroad jobs since deregulation has been unprecedented. In 1980, Class I railroad employment was 443,700.[1] As of 1986, Class I employment totalled 275,800, a reduction of 38 percent, or 167,900 employees. From a total industry perspective,[2] the Railroad Retirement Board shows a similar 36.5 percent decline in employment (1980-1986) to 338,000 in 1986. Moreover, numerous larger railroads have announced plans for further worker reductions, with some individual carriers anticipating reductions as extensive as 13,000 people over the next several years.

Rationalization of the rail network has been a continual process since the 1920's, when miles of road peaked at approximately 250,000. By 1980, railroads had reduced their systems to about 175,000 miles of road. Since 1980, Class I carriers have greatly accelerated the rationalization process through permanent abandonments as well as the sale of trackage.

Railroads must obtain approval from the Interstate Commerce Commission before they may abandon or sell a line. During fiscal years 1981 through 1986, the ICC granted 1,269 abandonment applications encompassing 15,790 miles of road—9 percent of the total 1980 route mileage (Table 1).

TABLE 1.—RAIL LINE ABANDONMENT APPLICATIONS APPROVED BY THE ICC

	Number of applications	Miles of road
Fiscal year:		
1981	81	1,342
1982	381	5,151
1983	123	2,454
1984	419	3,083
1985	148	2,343
1986	117	1,417
Total	1,269	15,790

Source: ICC annual reports to Congress, 1981-86 (App. B, table 5 or 6).

As this decade has evolved, the larger U.S. railroads have increasingly transferred rail mileage by selling to entrepreneurs, municipalities, shipper groups, and other railroads. This concept of line sales has spread to the point where it is practiced to varying degrees by generally all the larger Class I carriers. Table 2 illustrates that 148 new railroads—almost one-third of the railroads operating today—have been established after 1980. These railroads have preserved service over 11,153 miles of road, or more than 6 percent of the 1980 U.S. rail network.

TABLE 2.—RAILROADS ESTABLISHED SINCE 1980

	Number of carriers	Miles on road
Fiscal year:		
1981	9	494
1982	24	1,630
1983	22	514
1984	26	1,664
1985	29	2,385
1986	30	3,496
1987 (1st quarter)	8	970
Total	148	11,153

Source: Association of American Railroads, Profiles of U.S. Railroads.

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[1] As reported by the Class I railroads to the Interstate Commerce Commission. This figure is computed for the railroads which had Class I status as of 1986, since several carriers were declassified between 1980 and 1986 due to their relative decline in freight revenues.

[2] For the U.S. Railroad Retirement Board's monthly reports of *Selected National and Railroad Data*. Includes the approximately 475 non-Class I roads and various rail industry associations, bureaus, and other non-operating companies.

In addition to the sale of excess of uneconomic rail mileage to newly-formed carriers, railroads have also sold track over the past six years to existing railroads which were established before 1980 as an extension or "add-on" to their existing physical plant. Included in this category would be, for example, portions of the liquidated Rock Island Railroad and the Milwaukee Road.

Question 7. How much money has the industry invested in piggyback, or TOFC/COFC, since 1980? What has been the industry's return on investment (ROI) on piggyback since 1980? How much of the railroads' total capital investment (calculated at both book and market value) is in piggyback-related facilities?

Answer. The individual railroads do not report, nor does the AAR collect, data which allows it to identify the total investment in, or profitability of, rail piggyback (TOFC/COFC) service. While industry-wide investment figures are available for intermodals facilities and equipment, excluded from these figures is the intermodal share of such fundamental asset accounts as track, roadway, locomotives, and structures other than TOFC/COFC. Likewise, absent from the railroad reported investment is the industry investment in intermodalism through Trailer Train—a company owned by 18 railroads for the purpose of supplying and administering a pool of "free-running" TOFC/COFC flat and other cars. Trailer Train owns 80-85 percent of the total railroad intermodal car fleet.

Profitability of intermodal service is not available at the AAR because the needed investment, other cost, and reliable revenue data are not available. However, a word of caution is offered in interpreting revenue-cost ratios to be a surrogate for return on investment. Revenue-cost ratios are ratios of revenue to average, variable cost, including a return on investment at the embedded cost rate. Those ratios do not include coverage of fixed costs nor do they reflect the full, true costs of capital. In this regard, for any specific component of traffic, these ratios may be substantially above incremental or marginal cost, and also provide significant returns on investment.

Question 8. The dim picture you paint of the industry does not appear to be shown in the individual companies annual reports and filings with the SEC, and the discussions in those documents about their railroad properties. Please explain this discrepancy.

Answer. The dim picture of the railroad industry portrayed in the documents presented to you is an accurate projection of the financial conditions of the railroad industry. We have focused on the present adverse conditions of railroads because of the continued threats to the industry by those who propose to increase Federal economic regulation of railroads. Thus, our purpose was one of pointing out to public policymakers that the railroad industry is a highly competitive industry which cannot withstand unnecessary, and costly, additional government controls.

Our review of the railroad corporate annual reports also reveals a picture which is not bright and glowing with success. In some of the reports, financial improvements have been noted, but these improvements compare with low earnings in prior years, and are still short of the returns that investors earn in other industries. In the last two years, those evaluations have become decidedly dimmer. The majority of railroad annual reports which we reviewed use such words as "flat," "no growth," and "declining," to describe their traffic levels. They are virtually unanimous in acknowledging significant price declines and drops in their average revenue per ton-mile. And they readily acknowledge the problems in their marketplace—the decline of smoke-stack industries, the competition from foreign markets, and the downsizing of products. Furthermore, a number of annual reports comment on the significant negative effect of the Tax Reform Act of 1986. The increase in railroad taxes results from the loss of investment tax credits, the harsher mimimum tax and the new rules regarding depreciation. In no railroad corporate annual report are returns on investment shown to be adequate, or even comparable with other industries with similar risks of investment.

Question 9. You have testified that any business that cannot earn its cost of capital is doomed to go out of business, that piggyback traffic, your fastest growing traffic, pays only about 112 percent of variable cost on average, and that on average the railroads must charge 152 percent of variable cost to earn the cost of capital. You have also testified that those piggyback rates are set by competition and therefore cannot be unilaterally increased. What do the railroads propose to do in the short term and the long term to make piggyback traffic earn its cost of capital?

Answer. To the extent that economies of scale and density exist in the railroad industry, piggyback traffic carried at rates in excess of the variable costs of transporting it makes a contribution to fixed costs and is "profitable" traffic. To the extent piggyback traffic requires new investment, then the rates charged must also be sufficient to provide an adequate return on that investment over the long term. I am confident that, to the extent of new investment, the railroads are anticipating rates sufficient to cover the cost of the capital being invested. To the extent that anticipation is not realized, I am equally certain that rail managers would scale back investment.

The fact that on average piggyback traffic moves at only 112 percent of variable cost does indicate very strong competitive pressure. But that does not rule out the possibility of rates sufficient to cover the cost of new investment for some of that traffic given the very large economies of scale and density that exist in the railroad industry.

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question 1. Many have charged that some Class I lines are divesting themselves of large regional segments merely as a means of escaping labor protection or as a more politically expedient means of abandoning unwanted track. What is your response to those statements?

Answer. I believe such statements confuse the issue. While it is true that the imposition of labor protection might impose such heavy costs as to foreclose a line sale, the imposition of labor protection on an abandonment is not a sufficient motivation for a line sale. The existence of a buyer for a line indicates that a line remains potentially viable, given the ability of the buyer to reduce operating costs and more effectively market the service. Most lines that reach the abandonment stage have lost that potential. Thus, the line sale is an option which benefits the shipper, the selling railroad and employees. Service is maintained for the shipper and traffic is maintained (and usually increased) for the seller along with proceeds from the sale that would normally exceed the liquidation value obtained in an abandonment. Jobs that would otherwise be lost are also retained.

Question 2. I am concerned that regional "spin-offs" not be used as a back door abandonment tool. Presently, the buyer and seller simply file a notice to the ICC, wait seven days, and go forward with the transaction without any real opportunity for the local community or other interested parties to know who will be operating the new railroad. Do you think the government should have any role in making certain that the acquiring entity in a regional "spin-off" is a technically and financially capable operator?

Answer. The process by which a carrier may sell regional "spin-off" lines to which the question refers is a result of the ICC's decision in Ex Parte No. 392 (Sub-No. 1), Class Exemption for the Acquisition and Operation of Rail Lines under 49 U.S.C. 10901, 1 I.C.C. 2d 819 (1986). There the ICC, drawing on its previous experience with spin-off sales, decided to exercise its exemption powers pursuant to 49 U.S.C. § 10505. In the Staggers Act Congress had expanded these powers and urged the ICC to use them whenever it felt regulation was unnecessary. In this instance the ICC determined that the regulatory hurdles erected by 49 U.S.C. § 10901, the statute which, among other things, governs line sales to non-carriers, served no real purpose, and in fact delayed and, in some cases, prevented, the sale of viable rail lines to worthy operators.

While it is true the truncated approval process described in the question is shorter and contains less procedural mechanisms than a contested abandonment application would, there are many factors which mitigate against the use of the line sale process as an abandonment device. The first is the ICC's practice, codified at 49 C.F.R. § 1150.32(c), of declaring any exemption void ab initio if the notice contains false or misleading information. In addition, the exemption statute, under subsection (d), reserves to the ICC the power to revoke an exemption if the circumstances call for it. With these two tools the ICC can adequately police the line sale process for abuses.

Regardless of the regulatory preventives, however, there are present in the railroad environment structural considerations which make the use of the line sale process an ill-advised replacement for abandonment. While carriers will resort to abandonment when a line fails as a going concern by not returning to the carrier in revenues that which has been invested in it, the large capital expenditures sunk into an abandoned line, such as road and track property and equipment, still can prove valuable for a carrier, either through deployment on lines of greater profitability or by being sold and converted to cash. Consequently, carriers do not let go of these properties cheaply, as can be seen in the multi-million dollar purchase prices charged for some of the regional spin-off lines.

The high entry cost of operating a regional railroad ensures that only serious entrepreneurs who are intent on long term success will choose to make the necessary investment. That regional spin-off lines are viewed as viable enterprises is further evidenced by the participation of such prestigious investment banking firms as First National Bank of Boston and Irving Trust and by the recent interest of venture capitalists. Parties such as these will not waste their funds in enterprises lacking technical and financial capability.

These new owners do not take over a line of railroad without first doing in-depth research into the feasibility of operating a line, which entails much contact with "interested parties." Accordingly, in many cases, shippers and labor and community representatives have been contacted months in advance of the sale, thereby allowing the new carrier a headstart in developing good relations with these parties.

It is unlikely that a community will suffer from the substitution of a small carrier for a larger one where economically marginal lines exist. The smaller operator has a greater stake in the community and is better able to work with local industries to develop the traffic necessary to the maintenance of rail service.

Finally, it is in the interest of the selling carrier that the new operation remain viable. The larger carrier will still depend on that line to feed traffic to the rest of its system. Only by selling the line to a capable operator can it ensure that the line produces the traffic which moved on the line prior to the sale.

Question 3. In the past, I have expressed some interest in FELA reform. I know the railroads and labor have been discussing this issue. Is there any chance for compromise on this issue?

Answer. The question asks about a compromise on FELA "reform." I do not think there is any possibility for compromise on reforming the FELA. The compensation of employee injuries under tort law as required by the FELA is an unredeemably bad system and the FELA should, therefore, be repealed. I would hope that, because a no-fault workers' compensation system is demonstrably superior to the FELA for both employees and management, an agreement to substitute such a system for the FELA is possible.

Question 4. I have seen some pretty ominous statistics on the problem confronting—or soon to confront—the railroad retirement system. What is it going to take to make that system solvent for the long term?

Answer. Any retirement system in which one worker is supporting three beneficiaries needs radical surgery. Unlike most private pension systems, the railroad retirement system is as much a creature of the Congress as it is of management and labor and some of the financial problems being experienced by the system are directly attributable to actions of the Federal Government. Consequently, the railroads alone cannot, nor should they be expected to, solve the system's problems. Similarly, current employees cannot bear the full brunt of the corrective actions that will be necessary. Those presently on the retirement rolls will also have to shoulder some of the load. Just how these burdens should be apportioned requires careful and thorough analysis. I believe it is a task for which a Presidential Commission is best suited and have urged the Congress to create such a Commission. The Ways and Means Subcommittee on Social Security on July 1, 1987, as part of its budget reconciliation recommendations, approved the establishment of a seven-member Commission on Railroad Retirement Reform "to perform a comprehensive study of alternative methods of securing the long-term viability of the railroad retirement system."

OTHER QUESTIONS AND THE ANSWERS

Question 1. You have previously expressed your belief that enactment of S. 676 could effectively place a cap on rail rates. Please elaborate on this.

Answer. The C.U.R.E. bill would achieve the effect of capping rail rates by its terms and by presumptions drawn from its terms. It is a canon of legislative construction that courts will not deem the Congress to be engaged in idle acts. Courts presume that if a section of a law is changed it was done with a purpose and they attempt to discern and give effect to that purpose.

If the Congress were to enact the C.U.R.E. bill, it would effect the following changes in existing law with respect to determining reasonable rate levels:

(1) Prescribe a new policy of encouraging and promoting "competitive transportation rates for domestically produced coal and other commodities and products in order to increase their competitive position in both domestic and export markets."

(2) Delete the provision which now requires the ICC to "recognize the policy of this title that rail carriers shall earn adequate revenues."

(3) Add a provision which substitutes for the foregoing deletion a requirement for affirmative findings as to a railroad's need for the opportunity to achieve revenue

adequacy, as to a railroad's need for rates in excess of the jurisdictional threshold (now 180 percent of variable cost), as to the relationship of the rate of cost of service (implicitly denigrating the reasonableness of demand-based pricing), and as to the efficiency of the railroad's entire rate structure (the Long-Cannon factors).

(4) Add a provision which shifts the burden of proof as to the reasonableness of a rate from the shipper to the carrier in cases where the rate has gone into effect without suspension or investigation by the ICC (the carriers already have the burden where the ICC concludes that evidence of the unreasonableness of a proposed rate warrants investigation of a rate before it takes effect). The burden would extend to all of the newly-required affirmative findings noted in item (3) above.

Having practiced law for many years, I have no doubts as to how these legislative changes would be used by counsel for shippers in rate reasonableness cases. They would argue that the new law plainly created an implied presumption of the unreasonableness of rates in excess of the jurisdictional threshold. What else could the Congress have been trying to do by telling the ICC that (1) it was now a prime national policy that the competitive position of coal be considered in determining the reasonableness of rail rates (i.e., railroads should subsidize coal producers), that (2) in determining rate reasonableness the ICC was no longer to recognize the policy that railroads "shall earn adequate revenues" but, to the contrary, it was to determine whether a railroad even needed the opportunity to earn adequate revenues, that (3) it should question whether a railroad needed to charge rates above the 180 percent threshold, that (4) it should give explicit consideration to the cost of rail service (while conspicuously omitting any requirement that the demand for rail service be considered), and that (5) it should require evidence from the railroad sufficient to support affirmative findings that it is not transporting any traffic at rates which did not contribute to going concern value, that other traffic was being charged as much as possible, and that no commodity was paying an unreasonable share of the railroad's overall revenues? The icing on their argument would be that the Congress did all of this with full knowledge that the industry's earnings were substandard but that it considered it necessary in terms of public policy to further restrict the railroads' ability to sustain even that level of earnings.

I believe both the ICC and reviewing courts could be led by such an argument to discern a plain congressional intent to place a heavy burden of proof on a railroad to show that any rate in excess of the jurisdictional threshold was reasonable, and that the end result would be an effective cap on rail rates—particularly rail coal rates—and sharply lower rail earnings.

Question 2. As you know, under current law, shippers have the burden of proof on rate reasonableness. In order to successfuly challenge a rate, a shipper must prove that the rate is unreasonably high. Given that the railroads hold all the information on this, do you feel this is a reasonable burden to place on shippers? Similarly, why do you feel a shifting of the burden under S. 676 would be so onerous on the railroads?

Answer. As indicated in my response to the previous question, the shippers do not now have the burden of proof as to rate reasonableness in all instances. Under existing law, the assignment of the burden of proof turns on the distinction between complaints challenging proposed new or changed rate and complaints challenging rate that are in effect. Whenever a rate charged a shipper is to be increased, or a rate for a new service is to be established, the shipper is given notice and an opportunity to protest the change and to seek its suspension and investigation. If the Commission finds market dominance and decides on the basis of the shipper's protest to suspend and/or investigate, the carrier has the burden of proving the proposed increase is reasonable.[1] If, based on the carrier's response to the protest, the Commission refuses to suspend and/or investigate, the shipper is given a second bite at the apple—it may file a complaint after the rate goes into effect. In taking the second bite, however, the shipper also assumes the burden of proof.

Under the proposed bill, a shipper could protest any proposed rate increase and if, based on the carrier's response, it failed to secure an investigation, it could file a complaint. However, instead of having to come forward with evidence as to the unreasonableness of the rate, it could sit back and require the railroad to come forward again with evidence as to the reasonableness of the rate. If the shipper was not sanguine about the prospects of effectively rebutting that evidence, it would simply withdraw its complaint. Thus, for every rate increase subject to the jurisdiction of the Commission, a shipper could put a railroad through the regulatory wringer twice simply by filing two pieces of paper—complaints before and after the rate takes effect.

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[1] The Commission may not suspend or investigate a rate increase that does not exceed 4% above the railroads' inflation index unless the rate as increased equals or exceeds 190% of variable cost.

The existing apportionment of the burden of proof has been in place for most of this century. It comports with the general principle that the moving party carries the burden and, to my knowledge, no serious question as to its fairness has been raised before now. It is raised by C.U.R.E. as part of C.U.R.E.'s argument that railroads should be regulated like electric utilities and, because the utilities have the burden of proof as to their need for proposed rate increases, so should the railroads. But that argument conveniently overlooks the fact that, in the same circumstances—i.e., the pendency of a proposed rate increase—the railroads do have the burden of persuading the ICC that there are no grounds for an investigation. Failing that, the railroads have the burden of proof in the investigation. Only after a rate becomes effective does a shipper challenging the rate have the burden. And in that respect, too, the railroads are like utilities because a customer challenging a utility rate that had been allowed to go into effect would have the burden of proof.

As to how onerous to the railroads such a shift in the burden of proof would be, I refer to my answer to the first question in this set. By creating the need for affirmative findings on a wide range of matters the burden would be an exceedingly heavy one. But leaving the weight of the burden aside, why should the railroads be treated differently than all other defendants in our legal system by being required to carry the burden of proof in complaints brought against actions they have taken? In the cases with which C.U.R.E. is concerned, the complainants have legal and analytical resources equal or superior to those of the railroads. There can certainly be no doubt as to their capability of bearing the burden.

Question 3. You have characterized Section 9 of S. 676 as providing trackage rights at "non-compensatory" prices. Can you explain this further, as well as your objections to competitive access as identified by the NIT League and the Procompetitive Rail Steering Committee?

Answer. Existing law provides that where trackage rights are imposed and the parties cannot agree on compensation, the compensation shall be established by the ICC "under the principle controlling compensation in condemnation proceedings." (49 U.S.C. 11103(a)) The compensation principle guiding condemnation cases can be simply stated—the owner is to be put in as good a position pecuniarily as he would have occupied if his property had not been taken.

Section 9 of the C.U.R.E. bill would delete the above-quoted standard of compensation and, in lieu thereof, provide that compensation". . . shall not exceed the costs incurred by the owning carrier in making its facilities available for use by the other carrier (including both variable costs and an allocated share of the fixed costs and a reasonable return, associated with the facilities actually being used by the other carrier)."

Two of the implications of this change are obvious. First, the Congress would be expressly rejecting the condemnation standard which makes the owner whole. Second, it would be adopting a cost-based standard which takes no account of the revenue lost by the landlord carrier and which limits the costs to be borne by the tenant carrier to those associated with the facilities "actually being used." The latter ignores the fact that a railroad is a "system" and, although each shipper does not use each element of the system, each benefits from the existence of the entire system because it creates economies of scale.

Under the formula of section 9 it is quite likely that trackage rights would be sought only for the purpose of serving the most profitable traffic. This "cherry-picking" would very likely take from the landlord carrier revenues disproportionate to costs, otherwise neither the tenant carrier nor shipper could gain from the transaction. The wide-spread practice of cherry-picking would ultimately weaken, if not destroy, the entire rail system because its effect would be to severely restrain the differential pricing necessary to recover total rail costs. The probability of that result is the basis for our objection to both the C.U.R.E. and NIT League proposals.

Senator EXON. Thank you, Mr. Dempsey.

Mr. Hughes.

STATEMENT OF DAVID J. HUGHES, EXECUTIVE VICE PRESIDENT, BANGOR AND AROOSTOOK RAILROAD CO., ON BEHALF OF REGIONAL RAILROADS OF AMERICA

Mr. HUGHES. Thank you, Mr. Chairman.

I appear today on behalf of Regional Railroads of America.

RRA is a new organization. It is comprised of 47 small businesses which provide local and regional railroad service in 36 states, with 5,300 employees and handling about 1.3 million carloads of business a year.

On behalf of our membership, I would like to make two fundamental points here today.

The first is that regional railroads bring a new vitality and entrepreneurial spirit in the railroad business, which has been sorely needed for a number of years.

As a result of the regional railroad movement, we have avoided abandonment of thousands of miles of railroad and preserved thousands of railroad jobs. And, if Congress is willing, that is just the beginning.

Currently, regional railroads are being formed at the rate of two per month, and that will continue so long as the opportunity exists.

But I think it is a little early to celebrate. The regional railroad movement is fragile.

Of the 149 regional railroads formed since the Staggers Act was passed, 29 have already been liquidated. Our members operate on the economic fringe of the railroad industry. In fact, I think you could consider them as the capillaries of the railroad system. As such, they are susceptible to damage from a hostile economic environment or inappropriate Federal legislation.

The second point I would like to make with you is that trucking deregulation and the Staggers Act combined have brought mighty competitive pressure on the prices that we can charge for our services. At the same time, many of our costs are still dominated by Federal legislation, which is unique to railroads and not part of the cost of our competitors. It has placed us at an untenable disadvantage vis-a-vis the trucking industry.

It is the goal and mission of our organization to obtain the changes in that body of Federal law which disadvantages our members vis-a-vis other small businesses.

I should point out that of the things we would like to see changed, not a single change represents special treatment under the law. Rather, each change represents a change which would treat small businesses in the railroad industry exactly like small businesses in any other industry.

There are four particular areas of government-imposed burdens which are of immediate concern to us.

The first is government-mandated labor protection.

Second is the Federal Employer's Liability Act, our Workmen's Compensation Plan, the Railway Labor Act and the Railroad Retirement and Unemployment System.

Concerning labor protection, we think it is essentially a collective bargaining issue, just as it is in every other industry, and not something which can be efficiently handled by government fiat.

Concerning the Federal Employer's Liability Act, it is simply a well established lawyer's bonanza and a crap shoot for both employees and employers alike. We think FELA should be repealed or amended to bring it into conformance with the general standards of State Workmen's Compensation Systems.

Now, concerning the Railway Labor Act, I would like to suggest to you that it is something of an anachronism as it stands today. I think you need to look back to the way things were in 1926, when the Railway Labor Act was passed. Congress does not pass laws without some pretty profound provocation, and in this case I am sure there was good cause. Prohibition was nine years old, Al Capone's career was in its ascendancy, it was the dawn of the rubber revolution and we were starting to use cars and trucks a great deal more.

But, even at that, almost 100 percent of all of the inter-city passenger and freight business still was moved by railroads.

It had only been a few years since government seizure of the railroads had been ended as a result of defending the country in World War I.

In this environment, the railroad industry was the absolute heart of economic activity in our country, and it was absolutely essential that we have stability in that area of economic endeavor.

Today the situation is entirely different. There is no inter-city passenger service provided by regional railroads. There is fierce competition for our freight business. Regional railroads are important and will continue to be important, but there are alternatives in almost every case. It may cost a little more, but there is an alternative in virtually every case to a regional railroad.

The role of railroads in 1987 is very different than the role of regional railroads in 1926. In 1926, stability was what was in the public interest. In 1987, more than anything else, we need the ability to adapt to the competitive environment that presses on us so powerfully.

We simply are unable to adapt under a law which permits interminable delays and negotiations, frequent government intervention, and the constant threat of secondary picketing.

We would like to see the Railway Labor Act amended to bring it more closely into conformance with the Taft-Hartley Act, to prevent secondary activity and to permit swift and sure resolution of disputer without government intervention.

The Railroad Retirement and Unemployment System is a special concern to us because of the current and future magnitude of the costs it imposes. These are crippling costs for railroads and they will only get worse under the present scheme of things.

It is not a problem that is the making of railway labor or of railway management. Rather, it is a problem which results from government investment, user charge, and vehicle size and weight policies. These policies combined have shifted massive amounts of employment out of the rail industry and into the highway area, leaving railroad companies holding the bag for tens of thousands of employees who retired from a very much larger national railroad system.

We do not presume to have the answer to the railroad retirement problem, but we are sure what the answer cannot be. It cannot be a continual upward spiral of payroll taxes.

We suggest a comprehensive study commission to investigate possible solutions to the railroad retirement crisis.

I would like to say a couple of words about the Staggers Act and CURE.

While Regional Railroads has not yet taken a formal position on it, I would like to offer my own views because the outcome of these hearings may very well result in action on the CURE proposals.

On balance, it is my view, and I believe it is the view of very many railroads of the same size as my company, the Staggers has been a great success. The enactment of the CURE proposals, a I understand them, would be a major step backward.

The competitive access provision would destroy the incentive for companies like mine to invest, and it could very well result in the destruction of our companies.

The State regulation provision simply has no justification in my mind.

The short-haul business, that is intra-state in my company, and about half of our business is short-haul and intra-state, is intensively competitive and the lowest rated business that we handle.

In short, I think State regulation would be costly, time consuming, and result in the same old political circus that we used to be involved in in the past.

We also think the exemption authority, which was provided under Staggers, is important. It has permitted the prompt consummation of many line sales and has saved thousands of miles of track and thousands of railroad jobs.

It has also reduced the regulatory inertia that is so deadening to innovation. We would hate to see it lost.

In short, my view is that CURE is a case of political opportunism. It would be easy for a small railroad like mine to look for some "me too" protection because, after all, there is not a lot of difference between a small railroad and a captive shipper when it comes to negotiating with a very large carrier.

For now, however, I think that the risk of tinkering with Staggers far exceeds the risk of negotiating with larger railroads.

However, we might want to reserve the right to reconsider that as the years go on.

As a final point, I would like to say a word about our national transportation policy.

As you know very well, we have tried for decades to write one. The problem with writing a national transportation policy is that you have to enunciate whose interests will be favored and whose interests will be neglected. As a result, we really have not written one as a nation.

But we have definitely practiced one. The fact that you don't write it does not mean that you don't have it. You just do not admit what it is.

Railroads have been forced to bear many unique costs as a result of government activity. As I have said, we have a special pension plan, a special unemployment plan, a tort based workmen's compensation statute, and in many cases government mandated labor protection; while on the cost side, trucks and barges enjoy a right-of-way subsidy. So, railroads on the cost side are forced to bear extra costs. Our competitors are given a subsidy to one degree or another.

With respect to economic regulation, railroads are facing debilitating reregulation, while trucks enjoy near total deregulation.

In the area of labor law, the Railway Labor Act has frozen railroad work rules and craft lines in essentially their form of decades ago. Our labor costs, as Mr. Dempsey has said, are extremely high.

The trucking industry, on the other hand, has adapted rapidly to its new environment, and essentially our competition in the trucking industry and in the truckload area, at least, is essentially nonunion.

In the area of infrastructure, trucking and barges enjoy the productivity benefits of massive Federal investment, while railroads 'modest infrastructure programs, which were put in place by the 4–R Act have been essentially abolished.

The net result of transportation policy, written or not, has been a massive shift in employment from railroads to other modes of transportation. It has resulted in the destruction of railroad productivity and it threatens the bankruptcy of either the Railroad Retirement System or, alternately, perhaps, the railroad industry.

Gentlemen, we did not get into this trouble alone and we need your help to get out of it.

Thank you.

[The statement and questions and answers follow:]

David Hughes, Chairman
Regional Railroads of America

I am David Hughes, I am Executive Vice President of the Bangor and Aroostook Railroad of Bangor, Maine and Chairman of the Regional Railroads of America (RRA).

I am appearing here today on behalf of the RRA. Regional Railroads of America is a new organization which currently represents 47 regional and local railroads. The members of the RRA operate 8600 miles of track in 36 states. Our members employ 5300 individuals and we carry over 1.3 million carloads a year.

This Subcommittee has asked for our views regarding the overall financial well being of the railroad industry. You have asked that we assess the industry in terms of past, present and projected performance. You have requested our comment on proposals from within and from outside the railroad industry that could have an effect on railroad performance. Your future hearings will deal with specific testimony on the Interstate Commerce Commission's implementation of the Staggers Rail Act. While I will make specific comments and recommendations on behalf of the RRA, it is within the broad framework that I address my comments today.

There is a raging debate between the major class of railroad shippers, primarily from within the coal industry, and railroads on the economic health of our industry. You have just heard from Mr. William Dempsey, President of the Association of American Railroads. Rather than reiterate what you have just heard, I associate myself with Mr. Dempsey's remarks on the industry's fragile financial condition.

Surely there are valid differences of opinion as to the health of the industry and individual carriers. However, one conclusion is crystal clear to me. Railroads are not returning anything like the kind of return on capital that will be necessary to stay in business over the long term. Something must be done.

Financial Health of the Regionals

As a part of the basic strategy for survival, the Class I railroads have no option other than radical cost cutting. A necessary part of this program will continue to be the abandonment or sale of thousands of miles of line that do not produce an adequate return.

Fortunately, Chairman Heather Gradison and the Interstate Commerce Commission have expedited the option of line sales. The exemption under the Staggers Act as well as the decision not to impose labor protection has created a preference for preservation of rail service over abandonment.

As a result, regional railroads have become a growing entrepreneurial force in the shrinking railroad industry. Since 1980, 149 new companies have been established. This is a positive trend and many of these companies are healthy, indeed. However, by and large, regionals are troubled for many of the same reasons as the Class I's. We are a part of an interdependent industry. In addition, many of our new companies must take on substantial debt which requires new cash flow for debt service in order to operate old lines. That cash flow is based on traffic projections which at the very best are subject to everything from economic downturns to plant relocations to weather conditions.

Further, the railroad track and related infrastructure is often badly deteriorated by the time of acquisition. Internally generated cash for badly needed rehabilitation is often tight or nonexistant. Private financing is frequently not available for this purpose. This can result in slow trains, often running at ten miles per hour, which create large fuel and crew costs. At worst, these conditions can result in costly derailments. The Federal Railroad Administration's loan programs and the FRA's Local Rail Services grant program to states have been appropriately focused on the regional rail problem, and have been of help. Unfortunately, the Administration has placed their programs on the budget chopping block.

Thus while regional railroads are clearly a bright spot in the transportation industry, they too are troubled. Of the 149 new railroads established since Staggers, 29 have gone out of business. Regional and local railroads are capillaries of the railroad system. We operate on the economic fringe and are most suseptible to damage from a hostile economic enviornment.

These observations on the health of regional and local railroads is largely based on my personal knowledge. The growing regional phenomena is new, and we simply do not have the statistical information comparable to that of the Class I's. Several members of the RRA recently incorporated a non-profit Foundation for Railroad Productivity. During the coming months the Foundation will be developing a detailed profile of local and regional railroads. We will share this information with the Committee as it becomes available.

The Fundamental Problem in the Railroad Industry

Mr. Chairman, the fundamental problem is the national transportation policy as it impacts railroads. It is, simply, the policy that eminates from the sum total of all government programs that impact transportation.

The transportation policy of the United States is to take traffic off of the railroads and put it onto the highways. In my view, this is clear and indisputable.

I will only summarize the components of this policy. The decline of railroads and their market share is a direct result of federal investment in the nation's interstate highway and waterway systems. These programs created vigorous, subsidized truck and barge competition which has continuously eroded the market share of the railroad industry. The constant liberalization of truck sizes and weights, as well as increased speed limits, are year by year adding to the truckers' competitive edge. These competitive pressures are particularly felt by regional railroads which are universally locked into competition with trucks.

The second major factor in the government transportation policy is the non-productive cost that is forced on railroads by federal law. This cost particularly discriminates against regional and local railroads which must compete as small businesses. The major thrust of the RRA legislative program, which I will outline, is to end this extraordinary cost.

Three basic things need to be done:

1) The extra unproductive costs imposed on regional railroads by government programs and law, including labor protection, the Federal Employer's Liability Act, Railroad Retirement, and the Railroad Unemployment Insurance Act must be ended. These costs are unique to railroads and are not part of the costs of our competitors. This creates an untenable disadvantage vis a vis the trucking industry. Railroads must be given equal treatment with their truck and barge competition.

2) The labor productivity issue must be addressed. This should be an issue of collective bargaining outside the government. However, the Railway Labor Act must be reformed if collective bargaining is to have a realistic chance to work.

3) The government subsidy to our truck and barge competition must be equalized.

I should note, here, that I am fully aware that railroad management must bear the responsibility for finding innovative marketing and service opportunities and that ultimate success or failure will depend on the imagination and technology which we can bring to the industry. However, no amount of innovation can overcome antagonistic government policy and it is the government policy which your Committee and the other appropriate Committees of the Senate must study and correct.

The RRA Program -- the REAL CURE!

The RRA seeks to change that body of federal law that discriminates against their members as small businesses. Not a single change requested by RRA would provide special treatment under the law. Rather, each change would mean treatment identical to every other business in the country.

Today, the entire railroad industry employs fewer people than either General Motors, Ford, IBM, General Electric or AT&T. These companies are covered by modern day workers' compensation, unemployment compensation, collective bargaining and pension plan law. Only the railroad industry is required to operate under a set of laws enacted, for the most part, over one half century ago.

Labor Protection

The railroad industry, unlike any other industry in the United States, is required by federal law and regulation to provide payments of full wages and benefits for up to six years to employees that are affected by mergers, consolidations and rail line abandonments. Even those employees who are bumped into a new position as a result of their union's own senority rules are paid the difference between their old and new job.

These payments are referred to as "labor protection." They are really jobless benefits. These benefits are in addition to railroad unemployment insurance payments which in themselves are significantly superior to current state unemployment programs.

Initiated in the late 1930's, this so-called "labor protection" policy has not achieved the intended results. Since 1951, rail employment has declined 76%. Moreover, it threatens the development of regional and local railroads.

The Interstate Commerce Commission recognized the importance of maintaining service over local and regional railroads, and used the discretion it has to not impose "labor protection" on these transactions.

Legislation mandating costly "labor protection" passed the House of Representatives in the 99th Congress, and will apparently be reintroduced in the 100th Congress.

To survive, regional railroads must be given the chance to compete under the same unemployment and labor programs as all other small businesses in America. Protecting employees is an important and legitimate concern, but not an appropriate subject for federal legislation covering a single industry. These programs should be the result of collective bargaining, not Congressional mandate.

Federal Employer's Liability Act (FELA)

Enacted in 1908, the FELA is out of step with modern means of compensating persons injured in the workplace.

Every state in the union has a no-fault workers' compensation statute. These laws provide swift and certain recovery at guaranteed levels of compensation. The FELA requires injured railroad employees to engage in lengthy litigation for the mere possibility of successful tort claim. Damages in FELA cases are uncertain, and awards for any given type of injury may be completely inconsistent. The need for both employer and employee to prove negligence creates a hostile attitude between labor and management, and inhibits any meaningful effort to identify and correct the cause of an accident.

Industry wide cost rose from $343 million in 1980 to $526 million in 1985, an increase of 53%. While the cost of the system has skyrocketed, the number of workers it serves has decreased 34% during that same 5-year time period. One of the largest beneficiaries of this cost increase has been FELA attornies, who can earn as much as 40% of an individual claim.

For regional and local railroads the cost could become prohibitive, and may, on marginal lines, mean the difference between success and failure.

It is clear that the system is flawed. It is the position of the RRA that local and regional railroads should have the option of being brought under the state systems. At a minimum the FELA system is ripe for major reform.

Railroad Retirement

The Federal Railroad Retirement program imposes a so-called "Tier I" tax on employers of 7.15%, which is the equivalent of Social Security for all other businesses. It then imposes an additional 16.25% on the employer to fund a supplemental retirement system for railroad employees. No other industry in the country is required by federal law to fund such a system.

The economic handicap of railroad retirement is real. For example, let us say a regional railroad and a local trucking firm are competing to hire new employees at $24,000 per year. The trucking firm can hire seven employees for what it costs a railroad to hire six. That differential puts the railroad at an immediate and significant price disadvantage with its main competitor.

This year, the Administration is asking for a permanent 3% tax increase to insure the long run solvency of the supplemental retirement system. It is estimated that this increase will cost the industry $300 million a year.

However, employment in the railroad industry is declining at such a rapid rate that it is very unlikely that $300 million a year more out of the railroad industry will solve the problem. Some estimates indicate that it will take between $500 million to $1.7 billion more per year to put the System in sound condition.

To date, the response of government to the railroad retirement problem is to treat it as a railroad industry responsibility. This means ever increasing taxes to pay for Federally set benefit levels in the face of rapidly declining employment. This solution is no longer acceptable. This is especially true since federal policy is at the root of the problem.

The Railroad Retirement program was signed into law by President Roosevelt in 1934, ruled unconsititutional, reenacted in 1937 and affirmed by the Supreme Court. From the very beginning, railroad management expressed concern as to the source of benefit funds in the event of eroding railroad earnings. Ever since, it has always been a government program over which industry only had an advisory role. Benefits are set, taxes are levied and the program is administered by government. It was government policy that allowed dual windfall benefits to be paid to retirees for both Social Security and the Social Security equivalent in railroad retirement. This policy drained $9 billion from the System.

The old answers are no longer appropriate. It is Federal policy and the decline of basic industry that are at the source of the difficulty. In my opinion, to apply the taxes necessary to save the current system will bankrupt the industry--the more vulnerable regional and local railroads going down the drain first. The Retirement system is moving toward a crisis. Today, if you apply ERISA standards to railroad retirement, the fund is insolvent. New stop-gap taxes are not the answer. A total restructuring of the system must be undertaken. This must be done in full partnership with labor and the railroad industry and government. We only ask that the interest of the regional railroads be considered in the restructuring process.

Unemployment Compensation

A problem closely related to Railroad Retirement is the Railroad Unemployment program which is administered by the Retirement system. Since 1938, railroad employees have received unemployment benefits according to the Railroad Unemployment Insurance Act (RUIA).

Both coverage and premium payments are high and place a heavy burden on local and regional railroads. Like the Retirement program, declining railroad employment has created serious difficulty for RUIA. In fact the RUIA system consistently runs in the red and currently has a debt of $866 million to the Railroad Retirement Account.

The truck competition is covered by the state unemployment systems. Generally, benefits under RUIA exceed benefits in the state plans. Generous benefits together with the huge deficit combine to create a difficult burden for local and regional railroads.

We do not have a solution to this complex problem at this time. We would suggest that a commission established to explore retirement also take a hard look at RUIA. Certainly the system should be reformed. We would specifically ask a commission to address the option of allowing regional and local railroads to join in the unemployment systems of the states where they do business as an alternative to RUIA.

Railway Labor Act

What was it like in 1926? Prohibition was 9 years old and Al Capone ran wild in Chicago. We were at the dawn of the rubber revolution and rubber tired vehicles were produced in mass. Government seizure of the railroads for defense purposes in World War I had just ended. Railroads had a virtual monopoly on intercity passenger and freight transportation. The Railway Labor Act was passed to provide stability in transportation at any cost.

Today, there is no intercity passenger service on regional railroads and there is fierce competition for freight business. Regional railroads are very important--but alternatives exist.

Achieving full labor productivity in the railroad industry is vital if we are to stay in the competition. Many of the newer regional railroads have been able to achieve productive manpower arrangements that are appropriate to light density rail operations. Many of these new operations are organized by the unions; some are not. Often the pay scales are below national agreement levels, but are coupled with profit sharing. Arbitrary work rules and class and craft distinctions are almost always eliminated. These new carriers are pointing the way.

Older regional railroads such as the Bangor and Aroostook and the Central Vermont suffer from the same pay scales and working conditions and surplus employees as the Class I's. Change must come throughout the industry. It must come first with the older regional railroads. These changes should come through the collective bargaining process.

The difficulty is that the Railway Labor Act treats railroads differently from its competitors. The Act has built-in procedures for indefinite delay in resolving disputes. It has mechanisms for Presidential and Congressional intervention into the collective bargaining process. The RLA is particularly inappropriate for small operations. Under the RLA, unlike the Taft/Hartley Act, labor may spread a strike on a single property across the entire country through secondary picketing. This is a powerful and unfair weapon which can render the collective bargaining process virtually meaningless.

Local and regional carriers of the RRA ask only that they be able to resolve labor management disputes in a similar fashion to their trucking competition. We cannot adequately adapt to new economic realities under a law that permits interminable delays, frequent government intervention and secondary picketing. In 1926 the stability of rail operations was essential to the public interest. In 1987 adaptability is desperately needed.

Infrastructure

There is no question but that the federal investment in highway infrastructure has had the major impact on American railroading. Further, there is a substantial subsidy to the competing modes. Cost allocation studies at both the state and federal level show a pattern of underpayment by heavy trucks. According to the Federal Highway Cost Allocation Study, conducted by the U.S. Department of Transportation's Federal Highway Administration the heaviest trucks pay only 65.4% of their highway cost responsibility.

I believe it can be argued that the national railroad network is vital to the public interest as is the federal highway network. I would assert that freight transportation by rail achieves benefits that are equal to or better than freight transportation by truck. The advantages include: fuel efficiency, less environmental damage, better and safer highways for the automobile passenger. Additionally, the Department of Defense has expressed a very strong need for the railroads as a part of our strategic defense network. Therefore, it is bad policy to subsidize truck freight transportation at the expense of railroads.

To correct this policy, the trucks should be required to pay the full cost of their government provided right of way. If this is not to be the case, regional railroads, at least, should receive an equal government support for their infrastructure. The RRA has established an Infrastructure Committee under the Chairmanship of Mike Barron, CEO of the Ann Arbor Railroad of Michigan, to make legislative recommendations to the RRA on practical programs to equalize government infrastructure support.

The Staggers Act

The RRA has not taken a position on the CURE bill and will be discussing its provisions at an upcoming meeting later this month. Therefore, the following comments on the CURE bill are my own.

I felt it was necessary to comment because the outcome of this series of hearings will be a decision whether or not to move forward on the CURE proposals.

It is my opinion that the CURE package takes a major step toward reregulation of the industry and overall would be very damaging to large and small railroads. I am particularly concerned that the following CURE provisions will have a harmful effect on small railroads:

1) Competitive Access -- The CURE bill attempts insure that a shipper can demand competitive access of one carrier over the lines of another to serve a "captive" shipper. Small railroads as well as large railroads build extensive facilities to provide service exclusively for major shippers. In many cases, one or two large shippers dominate local and regional railroads. These shippers already have enormous power over the railroad. The ability to compel that railroad to make its facilities available to another carrier without proving anti-competive behavior is totally inappropriate. It would certainly quash new investment in railroad facilities serving a single shipper, and could give the shipper ultimate power to bankrupt a rail company and drive it out of business.

Large rail shippers are frequently a part of America's declining industrial base and are themselves in an intense competitive struggle. Necessarily, they use every weapon at their disposal to drive their costs down. Unquestionably, the weapon of competitive access could, and probably would, be used as an ultimate weapon.

2) State Regulation -- The CURE bill returns control of intra state rail traffic to the Public Utility Commissions. Presently, the ICC must certify that a state's standards and procedures are in accordance with federal standards and procedures. The CURE bill would allow states to regulate in a manner "consistent with" federal law, leaving the ICC as a court of review. This would give the PUC's far greater flexibility to create a seperate but "consistent" regulatory regime.

This would place local and regional railroads under two regulatory regimes. It would be costly, cause delays, and would present an unfair burden on small railroads which are frequently in only one or two states but which constantly interchange in interstate and national commerce.

3) Exemption Authority -- This provision retreats from the authority given the Interstate Commerce Commission to exempt fro regulation those transactions that are not necessary to carry ou transportation policy. The Interstate Commerce Commission used the exemption authority to expedite line sales, thus preserving thousands of miles of railroad. Any retreat from this would be counter productive, would inhibit the formation of new regional and local railroads and would lead to increased abandonments.

Overall, it is my view that the CURE bill represents one giant step backward to substantial re-regulation which will push the railroad industry into the pit of further depressed earnings and individual companies over the cliff of bankruptcy and liquidation.

Responses of David Hughes
to Additional Questions Posed by
Senator Hollings and Senator Pressler

Questions by Senator Hollings

Investment in Regional Railroads

The trend toward regional railroads is a new phenomena, born out of the freedoms provided under the Staggers Act and the willingness of the Interstate Commerce Commission to exempt line sales from costly labor protection. Operating with more productive work rules, individually negotiated wage incentive agreements and the flexibility a smaller company has to provide local service, these new railroads have the potential to operate previously marginal or money-losing lines at a profit. This is a new and exciting prospect, and as such it has attracted a great deal of investor interest.

It is important to note that this investment is high risk investment. While there are a number of banks involved in financing regional railroads, much of the money is from investment companies or newly created partnerships established specifically for these new ventures. While the term is generally applied to the technology industry, it would be fair to say that the majority of this new investment is venture capital. Like their counterparts in the technology industry, these venture capitalists are betting on the potential of new regional railroads not the performance of traditional Class I railroads. It is still too early to tell if that potential will be realized. If the issues RRA is asking the Congress to address are not dealt with, we feel that potential will be jeopardized and that future investment will be severely limited.

Problems Faced By Regionals

Regional railroads begin with light traffic densities, the very reason the Class I is looking to rid itself of the asset in the first place. Due to the light traffic density, the selling railroad has minimized improvements and maintenance expenditures, leaving the new owners with abnormally high operating expenses, and costly rehabilitation requirements. Their debt-to-equity ratio is very high which requires a substantial cash flow for debt service. That cash flow is based on traffic projections which, at the very best, are subject to everything from economic downturns to plant relocations to weather conditions.

What this situation adds up to is very little room for error.

While a huge Class I railroad may be able to absorb, at least for a time, a labor protection expense, an increased railroad retirement tax or a large FELA judgement, a new regional railroad can not do so. Any one of those events could put the company out of business.

Labor Protection

The most damaging aspect of labor protection payments is the fact that it jeopardizes the sale by raising the purchase price beyond that which the asset itself is worth. Regardless of whom the actual labor protection expenses are imposed on, the cost is going to be reflected somewhere. Expenses imposed on the seller would be passed through to the buyer in the form of either an increased purchase price, less favorable terms or reduced interchange commitments. If the seller does not know all the costs, not an unusual situation where "bumping rights" come into play, it will assume the worst case scenario and make adjustments accordingly.

These increased costs either defeat the sale by making it economically infeasible, or defeat the purpose of the sale by undermining the financial viability of the local railroad and hindering its ability to provide competitive service to its shippers.

CURE Bill

Most local and regional railroads understand that their relationships with the major railroads must be based upon mutually beneficial arrangements, not government fiat. Small railroads know that they and their Class I connections must work as partners if they are to succeed in selling railroad service to shippers, most of whom have numerous transportation alternatives. They know that, if they persuade the government to force an unfavorable arrangement upon a major railroad partner, that partner would find 100 ways within the law to demonstrate its disinterest in participating wholeheartedly in the arrangement.

Moreover, most small railroads have no use for so-called competitive access provisions because they originate and terminate traffic on their own lines, and interchange that traffic with one or more Class I connections. However, small railroads fear that competitive access provisions could allow their connections to enter onto their lines and "cherry-pick" their most lucrative traffic. While the generally harmonious relations most small railroads enjoy with their Class I partners likely would preclude such practices, the small railroads see no benefit, and at least a hypothetical threat, in the adoption of so-called competitive access provisions.

Finally, most local and regional railroads oppose competitive access because it is poor public policy. The system of differential pricing that Congress adopted in the Staggers Act is working well. It has permitted a modest financial recovery in the railroad industry, while at the same time producing lower rates for shippers. The so-called competitive access provisions of the CURE legislation -- in common with the rest of the proposed bill -- strike at the heart of differential pricing and would lead to cash starvation in the railroad industry. This starvation would harm small railroads because their Class I partners would be forced to defer maintenance, reduce car supply, and cut service as they did during the 1970's in an effort to remain financially afloat. This would reduce the competitiveness of the small railroad-Class I partnership, to the ultimate detriment of both large and small railroads and the vast majority of their shippers.

Questions by Senator Pressler

The Truck and Barge Subsidies

Waterways and highways are constructed and maintained by government. In both instances users pay a portion of the cost, but in neither case do those user fees cover the entire cost. The 1982 Federal Highway Cost Allocation Study(HCAS), updated for 1985, found that heavy trucks of 75,000 pounds gross vehicle weight or more paid only 65 percent of their cost responsibility. State studies have found comparable underpayments. Total highway spending in 1985 was $56.9 billion. For federal spending alone, the 1985 HCAS indicates that trucks 75,000 pounds and above paid $1,206.6 million in highway taxes. Applying the average 65 percent payment figure means they owed $1,845 million, leaving a gap of $638.4 million.

Waterway users receive an even larger percentage subsidy than heavy trucks. The Army Corps of Engineers spends annually some $575 million on shallow draft navigation, while annual barge industry user charges are only $50 million.

The only current federal subsidy received by the rail industry as a whole is the 90/10 matching grant money used for highway grade crossing repair.

FELA

The FELA should be repealed, and rail workers should be placed under the state's workers compensation systems.

The FELA is a fault based system which treats rail workers differently than all other workers in the country. It does not provide certain and swift compensation to injured workers. It does not foster good labor relations. It does not promote railroad safety. It is far costlier than the workers' compensation system used by the rest of American industry, and a large percentage of that cost is going directly to the lawyers that are the system's only consistent beneficiaries.

New regional and local railroads are particularly vulnerable. Trying to make marginal and money-losing lines operate at a profit, they can ill afford the FELA's excessive costs or contribution to labor management discord.

Senator EXON. Thank you very much.

Senator Kasten, do you have any questions now?

Senator KASTEN. Yes, I have some questions also, but I don't know if you would wish to go first. I have a couple of questions for both witnesses.

Senator EXON. Well, you are the ranking member, so why don't you proceed.

Senator KASTEN. Thank you.

Mr. Dempsey, I want to talk a little bit about the cash surplus issues that have been raised back and forth.

Those who view the railroads as being profitable cited to us the fact that some large railroads have been able to accumulate large amounts of cash, significantly large amounts of cash.

Could you just describe for us what the sources of those large amounts of cash have been. Is this cash earned by the charges? Is it earned by charging excessive rates? Is there a way that we can look to see one particular class of customers that would be relatively more profitable or relatively less?

How is it that the railroads, who, as your figures indicated, are not doing particularly well, how is it that some have been able to accumulate significant amounts of cash?

Mr. DEMPSEY. The answer is simple in principle. It is a little bit more complicated to explain in technical terms, but I will do my best and I hope to succeed.

There are a number of collateral reasons. For example, we had an equipment surplus of some magnitude coming into this period and, accordingly, we have had to make the normal kinds of expenditures for locomotives and cars and that sort of thing.

That has been a factor.

But far and away, the most important factor has been the 1981 Tax Act.

We benefitted in two ways. One, as a capital intensive industry, we benefitted by the accelerated depreciation that was granted in the 1981 Act, the five year write-off period, as did most of our customers, our shippers, who are also capital intensive.

Beyond that, there was an enormously important cash generator provision in that bill. This is the part that is a little bit technical.

It had to do with the way in which we treat expenditures on track which is a big component of our capital expenditures.

Before 1981, when we would replace track, we would write off that amount as an expense in the year in which taken. We had been doing that before the Federal income tax on corporations. We had been doing it forever.

Treasury did not like that. It thought that we, like everybody else, should be under ratable depreciation for track replacements.

We finally agreed to that because, primarily, of the shortened ratable depreciation periods in the 1981 Act. We could see that we could phase into that period without doing undo damage to the industry.

However, and here is the critically important factor, the original track expenditures made by the industry, when the track was laid down for the first time, were put in what we call a frozen account. They were never expensed. They were never depreciated. And, accordingly, Treasury obviously had to let us depreciate them.

And so, we were permitted to do that over a five year period. That generated about $2.5 billion in cash for the industry.

So, the combination of those two provisions in the 1981 Act is far and away the most important factor leading to the accumulation of significant amounts of cash by the industry.

Now that is all over, of course. That five year write-off is over. We now have last year's tax act, which will bear heavily upon the rail industry because of the extension of the ratable depreciation periods, and upon our customers. We regard it as a very damaging piece of legislation.

I am not saying that it is unwarranted. I am just saying that it is damaging to the industry. We cannot look forward to the tax laws as a source of generation of cash in the future, and we are going to have to begin replacing our fleet.

That is, in short, the explanation.

It certainly is not rates, because, as you have seen from the data that I have given, our rates have fallen.

Senator KASTEN. In a related area, a number of railroads have used surplus cash to purchase assets outside of the railroad industry, non-rail assets.

Do these acquisitions in a sense indicate that the railroads have so much money and that they are so profitable that they need to find other places for their cash? Or do these non-railroad purchases, the purchase of non-rail assets, indicate that the railroads themselves are not confident of their ability to continue to do the job they are doing and therefore want to diversify and get out of the railroad business, if you will?

Mr. DEMPSEY. I would say there are several reasons for this and several possible explanations. You will have some chief executives who have made these purchases before you later on, and they will be better able to answer, I suppose, than I am. But I think I can give you a pretty comprehensive answer to it.

It is suggested sometimes that these purchases indicate financial health of the industry. Well, when U.S. Steel bought Marathon Oil for billions of dollars, no one suggested that meant U.S. Steel was in good shape. What it meant was that it was retrenching and getting out of the steel business.

To some extent, that is true of some of these purchases. The railroad managers look at these figures and they see a cloudy future for the industry. They want to manage their money in the best way possible for their stockholders. They see attractive investment opportunities and they will put their money there, instead of in the rail business.

However, even apart from that, it is desirable for railroads to diversify because we have a very cyclical industry. So diversification is a reason all by itself.

Then there is the desire of some railroads, in particular, and CSX is an example, to become what they call "total transportation companies." And so, as you know, a number of these purchases have been not just in gas companies but in trucking companies, in steamship lines, and in barges, so that the whole transportation process can be integrated and they believe better managed.

Those are the reasons.

Some of the purchases were heavily leveraged. El Paso Natural Gas, for example, I understand, has paid for its purchase out of its own profit generation from the day that it was bought. So it did not require a large commitment of funds. Others did.

I made mention of some of the cash accumulation. You have to look at it railroad by railroad. For example, Norfolk Southern, last year I think it was, sold the stock that they had bought in the Santa Fe, and that improved their cash situation.

So it does vary from railroad to railroad. I think that is about what I would say about it.

Senator KASTEN. Mr. Chairman, thank you.

Senator EXON. Thank you.

Senator Rockefeller.

Senator ROCKEFELLER. Mr. Dempsey, you and I may not agree on all things, but I certainly have an enormous amount of respect for you. You are a tremendous professional in this whole area.

I am going to ask you a series of questions, and I would appreciate very much, since I am trying to lay some groundwork, if you would answer them as quickly as possible. You have the ability to cut down on my time by making longer answers, but I hope they are not going to be that kind of questions.

The Staggers Act deregulated competitive traffic, Mr. Dempsey, but continued to offer regulatory protection to captive traffic.

Is that your understanding?

Mr. DEMPSEY. Yes.

Senator ROCKEFELLER. How are competitive rates set? By the marketplace?

Mr. DEMPSEY. Yes.

Senator ROCKEFELLER. And what is that marketplace—trucks, barges, and the like?

Mr. DEMPSEY. Trucks, barges, railroads, and competing products, that is, substitute products.

Senator ROCKEFELLER. If any or all captive shipper rates go down, can the railroads increase their rates on competitive shippers?

Mr. DEMPSEY. Over the short-term, Senator, they would certainly try. That is what happened during the seventies, that act of desperation. Over the short-term, it takes shippers a while to change their distribution patterns. So they might be successful and might try it over the short run; but over the long run, I just have to think that the railroad are doing as well as they can in pricing competitive traffic up to the market.

So I do not think that those rate increases could hold in any major way.

Senator ROCKEFELLER. You testified, as I understand it, on June 3, before the House Transportation Subcommittee, that there could not be such a competitive rate increase. I understand that Mr. McKinnon has also said the same thing.

Mr. DEMPSEY. Essentially, that is right.

I am not saying that there would not be an effort and that it might not be successful in the short-run; but as a long-term solution, it would not last.

Senator ROCKEFELLER. But, essentially, for purposes of the present, there would not be a competitive increase.

Mr. **Dempsey**. I think I have said what I mean and that is the best I can do.

Senator **Rockefeller**. Is it your testimony that these captive shippers are not paying enough or that they should be paying more, that there should be more captive shippers, or that the competitive traffic is not paying enough?

Mr. **Dempsey**. Well, it certainly is not the latter because, as I have testified, I think one must assume and I am sure there are marketing people who make mistakes, but, on average, they try to maximize their profits, as you indicated. So it is not the latter. It is not that the noncaptive shippers are not paying enough in the sense that we could not get them to pay any more. Even with so-called "captive shippers" competitive forces are at work.

You and I might differ on how you define the captive shipper. Taking your definition of it. I am not in a position to say whether they ought to pay more or they ought to pay less. All I can do is describe what the facts are. If the railroads they could maximize their profits or improve their profit situation, again, by increasing rates on captive shippers, I assume they would do that.

So it is the railroads' judgment and not mine as to whether captive shippers ought to be paying more.

Senator **Rockefeller**. Mr. Dempsey, do you think it is possible to conclude that if the margins of the railroads are not what you would like them to be on an overall basis, is that not because your competitive traffic is not earning enough? That is the first part? Secondly is that you are having to make up that difference with captive traffic?

Mr. **Dempsey**. No.

We are talking about traffic now that by definition is competitive. Take our piggy-back traffic. It is our number two line of traffic now, and it is the most rapidly growing.

Well, we are in head-to-head competition with the trucks. Our average revenue to variable cost ratio for piggy-back is around 112 percent.

I just don't see any way in which those rates can be increased against that kind of competition. That is true of all the competitive traffic.

What we must do in that area is to increase our productivity, reduce our costs, and increase our profit while maintaining the same rate level. But we cannot do it.

If the industry could have done it by raising rates during this six year period of time, I assure you that they would have done it.

Senator **Rockefeller**. Have you not said or has not AAR said before that the piggy-back traffic , the so-called 112 percent that you are referring to, that if you really had to depend upon that, you would go broke——

Mr. **Dempsey**. Oh, yes.

Senator **Rockefeller** [contining]. Even though it is the fastest growing segment of your industry?

Mr. **Dempsey**. No question.

We have to average, Senator, on our traffic, about a 152 percent ratio in order to earn an adequate rate of return. No commodity that we have, including coal, hits that level. But, obviously, if we had to run the industry on 112 percent, we would be out of business in short order.

Senator **Rockefeller**. Thank you.

Mr. Dempsey, has the ICC found any major Class I railroad to be revenue adequate since the Staggers Act was passed?

Mr. **Dempsey**. Not to my knowledge.

Senator **Rockefeller**. Did not the ICC Chairman testify in the House two weeks ago that it was unlikely that they would find that to be the case in 1986?

Mr. **Dempsey**. In 1986, yes. I think it is. I cannot remember whether she testified to that.

Senator **Rockefeller**. You were there?

Mr. **Dempsey**. Yes, I was there and I listened to her. I just don't remember whether she said that or not.

But given the drop in our revenues in 1986 from 1985, I would think that that would be correct, although it is an individual railroad calculation, and so I cannot be certain.

Senator **Rockefeller**. Mr. Chairman, my time is up. I hope there will be another round.

Senator **Exon**. Thank you, Senator.

Mr. Dempsey, you indicated that the average salary in the industry was about $46,000. Is that the average of all employees of the railroad, including those under union contract and the executives, or is that those covered by collective bargaining only?

Mr. **Briggs**. Mr. Chairman, that is the average of all the employees. It includes not only wages but fringe benefits.

Mr. **Dempsey**. But does it include executives?

Mr. **Briggs**. It includes all employees. The number of nonunion employees would vary from railroad to railroad, from 7 percent to 3 percent. So most of it is union employees.

Senator **Kasten**. Did you say 7 to 3 or 7 to 30 percent?

Mr. **Briggs**. From 3 to 7 percent.

Senator **Kasten**. From 3 to 7 percent?

Mr. **Dempsey**. Yes.

Mr. **Briggs**. That would be nonunion.

Mr. **Dempsey**. We have some exempt clerical forces.

Mr. **Briggs**. They would not all be executives.

Mr. **Dempsey**. Yes. A lot of them would be clerks.

Senator **Exon**. Executive salaries are quite high in some of the railroads. Would that do much to raise the average?

Let me phrase the question in another way.

What is the average salary for those covered by collective bargaining?

Mr. **Briggs**. That number might drop $1,000 or $1,500 at the most. There are so many union employees in relationship to others, what you would think of as executives, rather than nonunion clericals, that it would not change much.

Senator **Exon**. So to answer my question, $44,000 in salary and fringe benefits would be a ballpark figure?

Mr. **Briggs**. Yes, sir.

Senator **Exon**. Mr. Hughes, what would that be in your railroad? Could you tell me?

Mr. **Hughes**. About $40,000, sir. We are slightly below that.

I should point out that our railroad is almost 100 years old. It is regional in size and scope, but not new in the sense that the new regional railroads are.

Mr. **Dempsey**. So, to make the point, the Bangor and Aroostook pretty much follows the collective bargaining standards established for the Class I railroads. That is not true of the new regionals. Their labor costs are substantially lower on average than the Class I railroads.

Senator **Exon**. I was trying to get a figure on that. If yours is $44,000, salary and fringe benefits, and yours, Mr. Hughes, is about $40,000, do you have any figures or know what the figures would be for new regional railroads?

Mr. **Hughes**. Not in exactly those terms. But what is clear is that regional railroads lowered their labor costs not by paying low wages but by having high productivity.

For instance, in train service, where wages are generally high in the railroad industry, the salaries are $120 to $140 a day, just salary, plus another 50 percent or so fringe benefits. So perhaps $200 a day would be a typical employee cost for a regional railroad. The difference is that a regional railroad generally operates a train with two employees, compared to four or five for a Class I railroad or for my company.

Senator **Exon**. Two employees per job. You talk about productivity. That is how you gain productivity. You have two people on these new regional railroads doing what are required under labor contract for three or four people to do in your road and in the major roads, is that right?

Mr. **Hughes**. Four or five people often.

Mr. **Dempsey**. Four or five.

Senator **Exon**. You used the term "productivity." Is that the right term, or is it reduced wage costs?

Mr. **Dempsey**. "Productivity" is the term I would use.

Mr. **Hughes**. Yes, I think that is right.

Senator **Exon**. What is right?

Mr. **Hughes**. "Productivity" is the correct term, sir.

Mr. **Dempsey**. It is the unit of production measured by the labor costs associated with that unit. So it is ton-miles produced in terms of the number of employee-hours necessary to produce the ton-mile.

Senator **Exon**. All right. I think we know what we are talking about, don't we? It is a nice term.

I don't know why we beat around the bush on these things. You have cheaper labor costs, and you call that increased productivity. Increased productivity, I think, to most businessmen in the United States means that you turn out more units of widgets or whatever you have per hour.

Mr. **Dempsey**. That's right.

Mr. **Hughes**. That's what he's doing.

Mr. **Dempsey**. That's what we are talking about.

Senator **Exon**. That's what you're talking about?

Mr. **Hughes**. Yes, sir.

Mr. **Dempsey**. We are turning out more ton-miles per employee hour, and not by virtue of reducing the wages of the employees, but by virtue of reducing the number of employees.

Senator **Exon**. Productivity, by and large, I think, is generally interpreted, maybe not in the railroad industry, as meaning if you had, an employee that made five widgets and he could make ten widgets, that would be a 100 percent increase in his productivity.

You are not saying that those employees are working that much longer or putting out that much more, but you have less people doing the work?

Mr. **Dempsey**. Well, it can be a combination.

If you are just talking about the crew size, then it is less people doing the same amount of work. If you are talking about changing the basis of pay—it is a very complicated basis that we have now—we are talking about having them work more hours for the same pay.

Senator **Exon**. The same pay?

Mr. **Dempsey**. Yes. Whether we call it reduced labor costs or increased productivity, we will take it however we can get it, whatever it is called.

Senator **Exon**. Is that what is happening, Mr. Hughes, from the new regional railroads? The engineer is working longer hours and making the same pay?

Mr. **Hughes**. No, sir.

The number of hours an engineer can work is limited by Federal law. What is happening is, for instance, it has been typical in the industry that a job might run 100 miles for a day's pay. The new regional railroads essentially eliminate the 100 mile standard, and they pay a daily rate. Often a train manned by two people might travel 300 miles in a day, and it may take eight or nine hours to do it.

Senator **Exon**. I have one other question of you, Mr. Dempsey.

You mentioned in your testimony that average rates for grain, based on inflation, had decreased about 44 percent, and the average rates for coal decreased at about 6.9 percent.

Is that right?

Mr. **Dempsey**. Yes, that's right.

Senator **Exon**. Why the big difference between grain and coal?

Mr. **Dempsey**. You know better than I do, Mr. Chairman, what the grain situation has been in the West: the radical decline in grain exports and the generally poor situation facing the grain shippers. The railroads have done their level best to keep that grain moving and to keep the equipment moving, so as not to have it just sit around and cost money. So this has been the railroads' response to those competitive pressures that face the grain industry.

Now, of course, competitive pressures face the coal industry, too, but really not to the same degree of near disaster as some of the grain elements in the industry.

Senator **Exon**. Are you telling me, Mr. Dempsey, that corn and wheat farmers and other grain farmers of Nebraska are transporting their grain to market for almost half the cost of pre-Staggers?

Mr. **Dempsey**. Measured in real dollar terms. The shippers—now I am not saying that that is the individual farmer. The individual farmer is not the shipper on the unit grain train.

Surely, much of that savings must be passed back to the individual farmer. But I am in no position to say exactly how much of it is or in what fashion.

Senator **Exon**. You know, a lot of this is 50 unit trains and all of that more efficient hauling.

Mr. **Dempsey**. Sure.

Senator **Exon**. Rates of hauling, generally that is passed back to the farmers, is it not?

Mr. **Dempsey**. Yes, I believe it is.

Senator **Exon**. I am going to check to see whether the farmer is getting his share of the benefit from what looks to me to be rather a dramatic reduction in the hauling of grain, as you outlined it very well, Mr. Dempsey. They are doing that to help compete in a depressed agricultural market.

But they do not seem to be doing that, if they are doing that, in the coal business. I would think if the railroads are good enough to help out the farmers, they likewise might be good enough to help out the coal producers.

Mr. **Dempsey**. Well, there are differing views on that. But when you speak to executives from Southern and CSX, I think they will take the position that indeed they have been doing that. In the export market, for example, coal rail rates have gone down.

Now, they have not gone down to this dramatic degree, and it is a question as to how much you can take it down and still make some kind of return on your capital.

I should say that in actual terms, the grain rates have come down about 27 percent during this period of time.

So I think, when you are talking about having benefits flow back to the farmers and you are talking to the elevators, that is the kind of figure that they would be looking at, a 27 percent reduction.

We have a study, [1] Mr. Chairman, done I think for the University of Kansas on what has happened to grain rates under the Staggers Act and how it has impacted on the farmers.

We will pass that on to you.

Senator **Exon**. I would like to have it very much.

Senator **Exon**. Senator Danforth.

Senator **Danforth**. Mr. Chairman, I apologize for being late to the hearing. Let me say to the witnesses that if my questions are repetitious, just refer me to the record, if you want. I don't want you to have to sing the same song all over again if you have already sung it.

Why shouldn't we pass the CURE legislation? Would that be just a terrible thing as far as the railroads are concerned, if we were to pass it?

Mr. **Dempsey**. Well, I have a short answer and a long answer, Senator. I will start with the short one, and then, if you would like me to give more detail on it, I will.

Senator **Exon**. Let me interpose something here. The question is not out of line.

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[1] See "Impacts of Rail Deregulation on Marketing of Kansas Wheat" Under U.S. Department of Agriculture and Kansas State University Cooperative Agreement No. 13-45-A-5013, September, 1986.

I did say at the beginning that we will have three separate hearings, Senator Danforth. We have one coming up next particularly on the Staggers Act. However, I think your question still could be allowed because I said when I opened the hearing today, that notwithstanding my hope that we could stay essentially on the subject at hand, which is profitability of the railroads, I assumed that the CURE bill might sneak into the conversation somewhere along the line.

Senator **Danforth**. Let me rephrase the question, then.

To what extent has the Staggers Act affected the profitability of the railroads? Are the railroads today profitable? Is it a good business to be in? And would the CURE legislation affect the profitability of railroads?

Mr. **Dempsey**. There is no question that the Staggers Act has improved the economic strength of the industry. I did not mean to give the impression in displaying these data that the industry is not in stronger financial condition now than it was prior to Staggers, even though the financial indicators are down.

The track is in good shape. Enormous capital investments have been made out of the cash flow that has been generated by the 1981 Tax Act.

But the industry is well positioned. Its service has improved dramatically.

Senator **Exon**. Let me point out here, just so we keep things straight here, that the question was with regard to the Staggers Act and what it has done to the railroads. The fact that the tracks have been fixed up, that is part of the Tax Act. It had nothing to do with Staggers, right?

Mr. **Dempsey**. Yes. I just wanted to make certain that I did not give the impression that the industry is about to fall over the cliff tomorrow. That is all.

The Staggers Act surely has helped enormously in the view of every manager that I know of in the rail industry.

Now I cannot quantify that and I don't think anyone can. We can give examples. Piggy-back traffic has shot up roughly 100 percent in this period of time. It never would have happened without deregulation.

Fresh fruits and vegetables now are a significant line of commerce. That never would have happened without an exemption under the Staggers Act. So we can catalogue it that way.

It has been a great help. I have no doubt that in the recession of 1981 and 1982, we would have had more bankruptcies but for Staggers.

The CURE bill—I will just give my short answer to that—and what would it do to the industry. I am sure that when we get into the hearings on CURE, we will be talking about how much reregulation really is involved and all of that.

I look at the rate provisions of the CURE bill and what I see, and what a lot of other people see, is an effort to move rail rates down to as close to 180 percent of revenue to variable costs as possible.

Now there is not a cap as such in the bill. But the burden of proof shifts to the railroads when rates go above 180 percent. If I were the Commission and I saw that the Staggers Act contained no presumption of illegality at all—over 180 percent—and saw that the preexisting scheme with respect to burden of proof was retained in Staggers, so that the shipper had the burden of proof in a complaint case, and then I saw legislative history with respect to captive shippers and coal rates and other kinds of rates above our 180 percent and a statute that shifts the burden at 180 percent, even were the Commission "brain dead," as the term as alleged by someone on the House Committee, they would get the message. Rates would go down.

Now, would they go down to 180 percent? Well, since it is not an absolute cap, I don't know. But if they did, the industry would have been, in 1985, $77 million in the red. That is a going out of business sale.

If it were only partially successful and the rates went down to 200 percent on average, we would have lost, we earned about $1.4 billion in 1986, or 1985—I have forgotten—and it would have taken $1 billion of that $1.4 billion, or about two-thirds, of our net profit.

That is one of the problem that we see in CURE, but it is a major one.

Senator DANFORTH. Has railroad profitability been won on the backs of captive shippers? Or do you just dismiss the concern of captive shippers? Do you think that that is just a point that is not well taken?

Mr. DEMPSEY. No. I do not by any means dismiss the concerns of captive shippers. They have every right to be concerned and to have the protection that the Staggers Act intended to give them.

These are our most important customers. They are the ones who depend on the rails, and the rails depend on them.

Senator DANFORTH. Is there some measurement—and I know I am interrupting your answer and I want you to go back to it—is there a measurement of what portion of transportation is captive and what is not?

Mr. DEMPSEY. Well, that is difficult.

If you talk to the marketing people in the industry and the chief executives, they will say that so far as they are concerned, there is no commodity or no shipper that is captive.

If you are talking, for example, about a coal mine on a single railroad that has no access to another railroad, what they will say is well, it is true that that coal mine is captive to us. But, on the other hand, we are competing with another railroad for this utilities traffic. He has a coal mine over there, and so we are captive to the coal mine as the coal mine is to us.

Now, if you look at it differently, as Senator Rockefeller does, I know, and say if we are just talking about shippers that have no transportation alternative—let's just define it that way, with no other railroad, no motor carriers, no steamship line—the best I can do is to cite you to a report that I think the Kearny Associates made for the Commission some years ago. Their conclusion was that about 10 percent, maybe 15 percent, of railroad traffic was captive in that sense.

Do the profits come on the backs of the captive shippers?

I have heard some people say well, you have admitted, Mr. Dempsey—as I just did—that if you roll the rates back to 180 percent, you would lose all of your profits. Therefore, they say, the profits come on the backs of the captive shippers.

My answer to that is, if you eliminate all the traffic below 180 percent, we would lose even more money.

So, obviously, our revenues are contributed by all the shippers. To the extent the market will enable us to do so, we must get those contributions to overhead from all categories of shippers.

Senator DANFORTH. Thank you, Mr. Chairman.

Senator EXON. Senator Kasten.

Senator KASTEN. Mr. Chairman, thank you.

Mr. Hughes, first of all, let me make sure we understand this wage-productivity question, because it was a little bit confusing.

Basically, your workforce is paid at roughly the same per hour wage, or per day wage, that is prevalent in the industry. Is that correct? You pay slightly less, but it is not as if the regional and short-line railroads are surviving today because you have drastically cut wages.

Mr. HUGHES. That's correct.

Senator KASTEN. Your wages are roughly 5 to 10 percent below, is that what you said?

Mr. HUGHES. That's correct.

Senator KASTEN. And what you have done instead is to either increase the work each employee is doing or increase the productive hours in his day; but his pay is still close to $40,000 a year on an annual basis, including fringes.

Mr. HUGHES. That's correct.

Senator KASTEN. And the reason that you are able to get the productivity gains that you state is because you were able, through labor negotiations and contracts, to work yourself around some of the costly and unproductive work rules that have been associated with certain parts of the railroad industry. Is that fair?

Mr. HUGHES. Yes, sir. That is correct also.

Senator KASTEN. What kind of changes are you able to make? Could you be specific with maybe one or two examples with the kind of work rules that the industry must work with and that you, for one reason or another, have been able to negotiate a more flexible approach?

Mr. HUGHES. Yes, sir.

Perhaps the classic example is what we call in the railroad industry the dual basis of pay. Some jobs are paid on essentially an hourly basis, those that operate in yards and in a fixed location.

The second basis of pay is a mileage basis of pay, which provides that there is one day's pay paid for each 100 miles the crew travels. Essentially a day's pay is roughly $100.

So, if you have a train, particularly in the West, that travels at 60 miles an hour, it takes about 90 minutes to earn a day's pay. Therefore, it is easy to earn three, four, or more days' pay in an eight hour period.

Senator KASTEN. In that case, do you get paid three days' pay in three or four hours, or do you get paid one day's pay for 90 minutes of work and that is all the work you do on that day? Which happens?

Mr. HUGHES. In this particular case, they receive three days' pay.

Senator KASTEN. Three days' pay for three 90 minutes work periods?

Mr. HUGHES. Essentially that is right. Yes.

Senator KASTEN. Have you been able to change that?

Mr. HUGHES. What is typical on a regional railroad is, instead of talking about hourly or mileage pay, they talk about daily pay. The average daily pay for an engineer on an inter-city job is about $140 per day. Typically, that is a 10 hour day. He may work generally five days a week. So he is working a reasonably normal day, earning what by both standards is a very nice wage, and in those companies where those rules are employed, they generally have a profit-sharing plan as well for sharing productivity and profit improvements with the employees. I think there is generally a very high level of employee morale in those companies.

Senator KASTEN. Is there any way of judging—and I am thinking about safety performance or consumer satisfaction or on-time shipments—is there any way of judging whether or not service is being improved or whether service is getting worse as a result of some of these changes that you have made in these labor provisions?

Mr. HUGHES. That is a qualitative question. But I think there is a universal, to my knowledge a universal view by the shippers who have been served by new start-up regional railroads, that they consider their service better for a couple of reasons.

First, because of the improved productivity of labor, the general volume of service provided in almost all cases goes up. Second, by having a small company serving the shipper, they are very much more attentive to individual shippers. So the combination of better attention and more productive work rules permitting better service I think has caused a much higher level of shipper satisfaction. But I am sure there are shippers who could testify about that more properly.

Senator KASTEN. That answer really is not the one I wanted because you are saying the shippers are happy, but compared to what? Compared to no railroad at all, which is really their alternative. I mean, the short line, as I understand it, most of the regional and short line railroads are unlikely even to be in business if it were not for the fact that you are able to make some of these kinds of changes through labor negotiations.

So, if you ask a shipper, whether he prefers a railroad or no railroad at all he will prefer a railroad.

Is there anything on an industry basis that would indicate, in terms of safety or other kinds of reporting, that your railroads are roughly as efficient, roughly as on time, roughly as safe, or more safe, more on time? There are no kind of statistics that would indicate that to us?

Mr. HUGHES. You know, this is only a phenomenon that is a couple of years old. There are not well developed statistics. Small railroads are not required to report in the same detail, fortunately in the same detail, as larger railroads.

The comparison I would make is not the choice between a shipper having service and no service. Certainly he would be happier with any service than none. But these are shippers who are contrasting the service that they have under a new regional railroad with the service they experienced with a previous railroad.

Senator KASTEN. My time is up.

Mr. Dempsey, do you have anything to add to that answer?

Mr. **Dempsey**. I do not. My information is only anecdotal, but it corresponds with Mr. Hughes' impression that, generally speaking, the shippers being served by these new regionals are happier than they were before. They do have management that is indigenous and that has made a personal commitment to the financial welfare of enterprise.

So I think he is right, from all that I know.

Senator **Kasten**. Thank you, Mr. Chairman.

Senator **Exon**. Senator Rockefeller.

Senator **Rockefeller**. Mr. Dempsey, if I could just continue with this line of questioning. It is my understanding that Chairman Gradison testified on May 28 in the House, and in fact said so several times, that the Commission's findings on revenue adequacy are irrelevant. Do you agree?

Mr. **Dempsey**. No, I do not agree. I cannot defend or explain what she said, but I do not agree.

Senator **Rockefeller**. The ICC claims that it has revised its revenue adequacy to more accurately reflect the railroad industry's financial health. It has now released its results for the year 1985 and, once again, every major railroad is revenue inadequate.

Now, 1985 was a very interesting year. It was the year in which Secretary of Transportation Dole called the Norfolk Southern a very profitable company and therefore we could sell Conrail to Norfolk Southern. She also told us that Norfolk Southern had deep pockets.

1985 was the year that Norfolk Southern itself told us it was very strong and financially sound as a company. In 1985, the Federal Railroad Administrator, John Reilly, told us that the Norfolk Southern had tremendous financial resources. Goldman Sachs said Norfolk Southern is a financially strong and very well managed company.

And yet, the ICC says that in 1985 the two railroads that supplied 85 to 90 percent of the net income of this very profitable and financially strong parent company were both woefully revenue inadequate.

The New York Times on Sunday, this past Sunday, John Snow, President of CSX, said Norfolk Southern was producing very good earnings, was in very good shape. The article goes on to talk about Norfolk Southern's record profits.

The picture of the health of at least some railroads differs, obviously, from ICC's picture of it. How do you explain this discrepancy?

Mr. **Dempsey**. I am sorry, Senator. What was the discrepancy again? All of the things that you have listed?

Senator **Rockefeller**. All of these glorious statements from Wall Street and what the ICC said, and that is that it is revenue inadequate.

Mr. **Dempsey**. Let me make several points and then, as I say, you will have an opportunity to get more particulars from the CEO of the Norfolk & Western. To begin with, the Commission did not find that the Norfolk Southern was woefully inadequate.

They were the second strongest railroad in the United States on these last calculations, with the N&W segment at 9.05 percent and the Southern at 8.06, or roughly 8.5 percent, measured against a 13.6 percent target. So they were not woefully inadequate.

Now, the Norfolk Southern is a financially strong carrier. The Secretary said "very profitable." That is a phrase I would not use. "Profitable" and "financially strong" are terms that I would use. Largely because of the 1981 Tax Act, I believe that their cash reserves are something in the range of $900 million.

That is a financially strong company. They can weather storms, and they believed that there would be a synergistic impact or effect of their acquisition of Conrail. That was their judgment, that it would have bettered their position.

There is a big difference, Senator, between being profitable and being revenue adequate. Profitable means you are making a profit. You may make a substantial profit without being revenue adequate, because the test of revenue adequacy is a long-range test of making the cost of capital.

Now, you can go for some period of time without earning the cost of capital and then you will begin to try to find ways to get to that level and you will retrench. The industry has been disinvesting now for decades. You disinvest more and more and more.

You try to get to a core system. You cut your costs. You are always trying to get to that goal.

I have the hot dog concession at the Redskins, say, and I make $100,000 during the season. Well, I made a profit, but I could have put it in the bank and made more. Well, I do not want to stay in that business, and so next year I get the beer concession for the Orioles and I make $500,000. Now, I was profitable the first year, but the next year I am a lot more profitable and I am making what I could make elsewhere in the market.

Senator ROCKEFELLER. So Mr. Dempsey, then your testimony would be that railroads can be profitable, they may even be financially healthy, but still revenue inadequate?

Mr. DEMPSEY. Yes, that is right.

I should mention also that, of course, we are picking out the second strongest financial performance.

Senator ROCKEFELLER. I understand. But there has never been a railroad described by the ICC to be revenue adequate?

Mr. DEMPSEY. No major class I railroad.

Senator ROCKEFELLER. The annual reports, the registrations, the 10k reports for the Securities and Exchange Commission for such companies as CSX and Conrail, all of which are very obviously important to my state of West Virginia, according to the Securities and Exchange Commission laws and rules, companies are required to include in these documents all relevant and material information that investors would consider important.

Not one of these—and I have many of them here—asserts that the ICC has consistently found that the railroad companies are revenue inadequate.

If this is such an important concept, revenue adequacy, and if the ICC has finally gotten it right, then why do none of these documents contain this information? It is my impression, in fact, and I am not a lawyer, that there are tough civil and even criminal penalties for those failing to make full disclosure to shareholders and to the investment community.

Why is not revenue adequacy or inadequacy being disclosed?

Mr. **Dempsey**. You are in a field with which I am not familiar when you are talking SEC law. I can venture a guess and then perhaps the financial panel can pick up on it. I am certain that all of their filings disclose all relevant financial data, including return on equity, return on investment, and all of that.

And of course, that is how you calculate whether or not a railroad's revenue is adequate. But I think that is a term of art that is limited to the rail industry because of the Staggers Act.

In other words, I do not think that is anything that has broadscale use in the financial community or with respect to other businesses. So I do not see any reason why the rail industry should have to make some kind of a unique filing, or if they did then calculations with respect to revenue adequacy would have to be made for every company in the United States to be fair about it.

And they do not have to put that in their submissions. That is just a guess on my part. As I say, however, I am not familiar with the SEC law.

Senator **Rockefeller**. Mr. Chairman, if I may, I have a follow-up question. Norfolk Southern is an example—and it is the same with all of these railroads' annual reports that we have been through. It does not mention its revenue adequacy to its shareholders.

And in light of the good financial record, are they not in effect admitting that the ICC's revenue adequacy test is not an indication of profitability?

Mr. **Dempsey**. Well, they are, I suppose, saying what I said before. And if you wish to call it an admission, it is perfectly all right. I do say that profitability is not the same as revenue adequacy.

A railroad can be profitable, and many are in this list that you have. In fact, I suppose I do not know that anyone is running in the red right now. They all are profitable, some marginally, some more, some less profitable, without being revenue adequate.

The test of revenue adequacy was established in the Staggers Act as the target for long-run viability of the rail industry. It is subscribed to by some 56 economists in a statement that I am sure is in the record as the appropriate standard.

It is subscribed to by the utility community as the appropriate standard, and indeed is embodied in the CURE bill as the appropriate standard that is cost of capital. Now, there are debates about what ought to go into the calculation, but fundamentally that is embraced in the CURE legislation that you sponsor.

So there we are. The utility industry comes a lot closer and many times makes the current cost of capital, and over the long run has made it. An awful lot of industries in the United States do not. The steel industry does not. The ore, the lumber industry.

There are a lot of industries that do not make the current cost of capital, and in the end that will get them, and it will get us in the end.

Senator **Rockefeller**. Mr. Chairman, I have more questions. My time is at an end. I would inquire whether there will be a chance to ask any more?

Senator **Exon**. I think probably, in view of the second panel, I would tend to conclude the questioning of this round of witnesses for now. If you have further questions, may I suggest that you ask them to submit answers for the record, Senator Rockefeller.

Senator **Rockefeller**. That I will so do, Mr. Dempsey, and I appreciate your answers.

Mr. **Dempsey**. Thank you, Senator.

Senator **Exon**. I will try to be very brief.

I guess I am still somewhat puzzled by your definition of productivity. It seemed to me, Mr. Dempsey, that if I hired you at $10 an hour and you turned out ten widgets an hour, and if I could get you to turn out twelve widgets an hour, that is increased productivity.

Would you agree that is increased productivity?

Mr. **Dempsey**. Yes, that is Henry Ford's production line.

Senator **Exon**. Also, you are saying it is increased productivity, Mr. Dempsey, if I cut your salary to eight dollars an hour and you still turned out ten widgets? That is increasing productivity?

Mr. **Dempsey**. No. It is the unit of labor; it is not the cost of labor.

Mr. **Briggs**. Senator, there has been debate for decades over the true definition of productivity. A simplistic measure is the amount of physical inputs required to create an amount of physical outputs.

BLS uses that, and in that sense what we are telling you is that employment is down in the railroad industry about 40 percent, production is about the same level, so over six years we have had a 40 percent improvement in labor productivity. But of course, it is a question of costs. If in fact you pay a lot more for each unit of labor input at the end of this period than you did, it does not result in the dollars savings.

But if you look at the third measure, which is total factor productivity, then you look at the number of labor inputs, the number of hours worked, you look at the cost per hour, and you look at your other costs necessary to produce the products such as capital investment, you add them all up and you get total factor productivity.

But either of the three measures—physical measures, a measure that is weighted by price, or total factor productivity—you have had major gains in the industry, and in the opinion of most there are still greater gains to be made.

The regional railroads in some respects tap other resources than are those that are generally available to the larger railroads.

Senator **Exon**. Well, you go ahead and keep defining it the way you want to.

It seems to me that the bottom line figure is here that if you can lay off enough people and get your wage rates down—and I am not criticizing you for that. If that is your plan, if that is what is happening, you are reducing the number of employees.

Therefore, I say that is cost cutting, including costs of labor cutting. You call it productivity.

Mr. **Dempsey**. Well, I will accept that.

Senator **Exon**. Maybe we can get to this question, my last question. You have expressed concerns about the solvency of the railroad retirement fund. What are your suggestions for stabilizing these funds without adversely impacting those employees who depend on and who have contributed into the system and are looking forward to it?

Mr. **Dempsey**. Well, Senator, that is a question that I am not yet prepared to speak to for the industry. It is enormously complex.

We obviously have to protect the employees that are on the rolls, and at the same time, if this problem were to be solved or attempted to be solved by imposing taxes upon the rail industry to meet that need, I can say with absolute confidence that we are on the way out.

You cannot have a debt that, if funded, wipes out your entire net operating revenue and expect to continue to operate. So we have got to look at alternatives. We have to look at the benefit structure, which after all was imposed upon us essentially by the Congress, and see what kind of adjustments can be made that will not disappoint reasonable expectations on the part of retirees advancing toward retirement.

We have to see if any tightening up can be done in respect of benefits being paid now or increased or augmented benefits being paid now, and then we have to look and see what can be done in the way of taxes.

And I must say, I think we need to look at the Federal Government as well, because the reduced—our problem is employees in relation to retirees, the ratio now is 1 to 3. In social security it is 3 to 1. Now, why is that?

It is due in large measure to Federal policies, subsidies amounting to over a billion dollars a year to trucks and to barge lines, as Mr. Hughes has pointed out. It has been crippling in its impact on the industry.

Senator **Exon**. Just briefly, and then I will pass on to the next Senator, do you have any magic set of solutions to that dilemma which is still facing us? I will ask, Mr. Hughes, if you have any comment, and then Mr. Briggs, if you have any magical answers, we would sure like to have the answer to that riddle.

Mr. **Hughes**. No, sir. We simply think some kind of broad-based commission should be established to work the matter out. The amount of money is so great that there are no simple solutions, like an intra-industry solution. It simply cannot be within the sole confines of the industry.

Senator **Exon**. Do you have the same answer?

Mr. **Briggs**. Yes.

Senator **Exon**. Thank you very much.

Senator Pressler.

Senator **Kasten**. Mr. Chairman, it sounds like we have magical one-sentence solutions coming from Senator Biden down at the other end of the hall.

Senator **Exon**. And if we could get him in here, we would put him under oath.

Senator Pressler.

Senator **Pressler**. Mr. Chairman, I shall use a portion of my time to read parts of an opening statement.

Senator **Exon**. Please do, Senator.

OPENING STATEMENT BY SENATOR PRESSLER

Senator **Pressler**. Mr. Chairman, I really think that the time is right for a thorough review of the rail industry. There are many issues confronting the industry, which we just must address soon.

Now, much of the debate on our side has focused on the Staggers Act itself and the extent to which it should or should not be revised through the so-called CURE legislation. I do not come here today with any preconceived notion on that issue, and I hope to learn more of it during the course of the upcoming debate.

But I am extremely concerned about the impact of that legislation and possible amendments which may impact dramatically the development and vitality of regional and short line railroads. This aspect of the debate is of great importance to me and I hope it will not be overlooked as we go forward.

From the perspective of rural Midwestern states like South Dakota, regional and short line rail development has been one of the two bright spots on our horizon in the wake of railroad deregulation. I am concerned that these short line spinoffs not be used as a means of more politically expedient abandonments or backdoor escape from legitimate labor protection requirements.

But we must take care not to throw out the baby with the bathwater. In addition to the Staggers issues, I think we need to confront the politically sticky issues of what constitutes adequate labor protection, FELA, and liability insurance, railroad retirement, and the relationships between the large and small railroads.

I will not go into great details on the specifics of those issues again at this point. They were spelled out in some detail during the hearing I chaired last July in this subcommittee.

My concerns and others were also spelled out here. Also, I am pleased to see that we have David Hughes, chairman of the Regional Railroads of America, testifying here today. We have worked closely with the Regional Railroads of America and I have a great deal of respect for David. I know he has addressed already some of the issues to which I have referred.

In conclusion, Mr. Chairman, I come to this issue with an open mind on the CURE issue. But I would be very opposed to amendments jeopardizing the development of the smaller lines. This is not to say that that issue should not be a part of this debate.

We do need to develop a more coherent policy with respect to smaller lines, and I believe that there are strong justifications for encouraging their development as an alternative to abandonment. But I also feel that we need to articulate clearer guidelines in our treatment of them.

We must be careful to ensure that short line rail development not be used as a tool for back door abandonment and union busting. The present railroad versus non-railroad treatment leaves a great deal to be desired and does encourage abuse.

This needs to be addressed, and I look forward to working with labor, industry, and the shippers in an attempt to do this as we go forward with this process.

With that, I shall turn to some questions that I have, Mr. Chairman.

David Hughes, head of the Regional Railroads of America, you have pointed out that 29 of the 140 new railroads formed since 1980 have been liquidated. First, it would be useful to have a list of those railroads.

Second, let me ask you whether you think we should be doing more to make certain that the acquiring line is technically and financially able to run the line it seeks to purchase?

Mr. HUGHES. First, we will be happy to provide a list, Senator.

Second, I am inclined to think that the free market is a good judge of the adequacy of management and of business opportunities. The regional railroad movement in the past two or three years has brought about half a billion dollars of new capital into the railroad industry from essentially new investors, and it has brought in many cases a new set of managers in as well.

I think the jury is still out with respect to what the long term shakeout of that movement will be. But for now, I certainly see no reason to believe that government regulation or intervention is a better tool than the free market for deciding what should and should not be done.

[The following information was subsequently received for the record:]

REGIONAL RAILROADS OF AMERICA
324 Fourth Street, N.E.
Washington, D.C. 20002
202/543-0038

September 30, 1987

Mr. Robert Holleyman
Subcommittee on Surface Transportation
Senate Commerce Committee
428 Hart Senate Office Bldg.
Washington, D.C. 20510

Dear Bob:

In response to the question asked of me during my testimony before your Subcommittee in June regarding the names of 29 failed regional railroads, I have attached a list of those railroads. I apologize for the delay in providing this information.

The source for the statement that 29 regional railroads had failed prior to 1984 was a working paper prepared by Mr. John F. Due of the University of Illinois at Urbana-Champaign. The paper was an October, 1986 update of Mr. Due's 1984 study entitled "New Railroad Companies Formed to Take Over Abandoned or Spun-Off Lines". The 1986 paper was used as a reference source for my testimony.

In his 1986 update, Mr. Due made the statement that by April of 1984, 29 regional railroads had been liquidated. The paper did not provide the list of those railroads, and we had to contact Mr. Due to obtain that list (which is the reason for the delay in getting this response to you). However, in checking with Mr. Due and obtaining his original 1984 study, we discovered that he listed only 26 railroads or lines, not 29. We are now attempting to obtain the names of the other three, but did want to provide you with the 26 we do have.

Sincerely,

David Hughes
Chairman
Regional Railroads of America

REGIONAL RAILROADS THAT FAILED PRIOR TO APRIL, 1984

The following ventures either failed or were abandoned prior to April, 1984:

Ashuelot Line to Keene, N.H. - 24 miles
North Country-Ontraio Eastern (N.Y.) - 20 miles
Lykens Valley (PA) - 10 miles
Mercersburg (PA) - 14 miles
Maryland & Delaware's Easton-Dento line (DEL 7 MD) - 53 miles
Western Ohio (OH) - 25 miles
Ohi-Rail - 39 miles
Southwestern Oklahoma - 26 miles
Texas xport - 54 miles
Brandon, Clay Center-Manhattan (KS) - 36 miles
San Diego & Arizona Eastern (CAL) - 148 miles
Kent, Barry & Eaton (MI) - 48 miles
Erie Western-Chicago and Indiana - 195 miles
Decatur-Portland line (IND) - 21 miles
Indiana Interstate (IND) - 16 miles
Sparta-Viroqua (WIS) - 33 miles
Iowa Central (IA) - 60 miles
Keota-Washington (IA) - 15 miles
Keota-Washington, Iowa Falls-Vinton line (IA) - 28 miles
Raccoon River (IA) - 10 miles
Great Plains (NEB) - 85 miles
Portion of the Michigan Northern between Comstock Park and Reed City - 61 miles
Chippewa River (WIS) - 33 miles

The following three lines failed, but their operations were taken over by another shortline company:

Wabash Valley (ILL) - 75, now Prairie Central
Chicago, Maidson & Northern (WIS) - now operated by Central Wisconsin
South Central Arkansas - 26 miles, now run by East Camden and Highland

Senator **Pressler**. How do we make certain that regional railroad development is not used to, in effect, abandon a track or simply as a means of escaping labor protection? Indeed, perhaps I should ask you first if you think it should not be used for these purposes?

Mr. **Hughes**. Would you restate the question, please?

Senator **Pressler**. How do we make certain that regional railroad development is not used in effect to abandon a track or simply as a means of escaping labor protection? Indeed, perhaps I should first ask if you think it should not be used for these purposes?

Mr. **Hughes**. Well, I think that labor protection is a matter that should be a subject for collective bargaining between a railroad and its employees, and not something that should be a subject of mandatory government intervention. To the extent that the sale of railroad lines represents a change to a more efficient form of ownership and a more productive way of serving the public, then I think that is an appropriate restructuring of the railroad industry.

Senator **Pressler**. A final question, and this is to Mr. Dempsey. Mr. Dempsey, we hear a lot about the so-called captive shippers and the amount of profit railroads derive from them.

Would you concede that there are captive shippers out there? If so, what percentage of industry revenues do they represent?

Mr. **Dempsey**. Could I just respond briefly to the question of labor. A railroad does not avoid labor protection by selling track to a regional railroad except in the sense that the alternative would be to abandon the track and that would then generate labor protection.

The reason that the railroads sell to regional railroads is not to do that, but to keep the line in operation. That is to the advantage of the shippers, of the communities, and of the trunk line railroads because traffic keeps flowing and sometimes increases.

As to the captive shipper question, we have discussed it and I must say that it is a complicated matter, so let me try to answer it this way. Without endorsing this definition of captive shipper, my best guess is that using standards employed by the Commission the number of captive shippers that we have might represent something in the way of, oh, perhaps ten percent, maybe between five and ten percent of our traffic.

That is a guess, but it is a fairly educated guess and it does come close to our experience, I think.

As to the profit part of this question, I cannot tell you what revenues derive from that five to ten percent. What I can do, though, is to tell you what profits and what revenues are generated from all traffic above a ratio of 180 percent revenue to variable costs. That is the threshold for Commission jurisdiction.

Now, many of the shippers with rates above that would not be considered to be captive shippers, but I have no other break point. As to that, about 20 percent of our total traffic falls above that threshold and about 18 percent of coal falls above that threshold.

As I indicated, if our rates were all taken down to the 180 percent, we would lose all of our net operating profit plus some. So you can see that that is a major contribution.

If you were to consider that captive shippers by and large fell someplace above the 200 percent level and you took them all down to 200 percent, we would have lost a billion dollars in operating profits in 1985.

We can give you those figures on every increment—220, 225, 230. They are easily calculable. But then one just has to make up his own mind as to what level you can say, well, above that level they are probably captive. That is about the best we can do on that.

Senator PRESSLER. Mr. Chairman, I have some more questions which I shall submit for the record.

Senator EXON. I thank you, Senator Pressler. Before we go to the next panel, I am going to yield to Senator Rockefeller for two questions, no longer than two minutes by agreement. Senator Rockefeller.

Senator ROCKEFELLER. Mr. Dempsey, on the matter of the McCarty Farms case, does the AAR agree with that decision where the ICC found for the grain shippers?

Mr. DEMPSEY. My vice president for Law is here. I might ask him. I do not know that we have taken a position on it. I doubt that we have.

Mr. TIDD. We have not taken a position, but I doubt that we would agree with it.

Senator ROCKEFELLER. I doubt also that you are going to agree with it. Maybe you could also ask your general counsel if, as I suspect, the railroad is going to appeal.

Mr. TIDD. It is not our case.

Mr. DEMPSEY. We are not in the case, so it will not be up to us.

Senator ROCKEFELLER. Mr. Chairman, I am not a lawyer, as I said before, but I feel this probably would be appealed by the railroad.

Mr. DEMPSEY. Sir, it is not over yet.

Senator ROCKEFELLER. I understand that.

Mr. DEMPSEY. In other words, the proceeding to me is really odd. No evidence to speak of was put up on the rate reasonableness question, and yet the Commission held that the rate was unreasonable and then asked the parties to prove why it was not.

And it would be appealed probably on that ground, if nothing else. But it is not over and so we will just have to wait to see what happens after the evidence is put in.

Senator ROCKEFELLER. If it is appealed, however, when the case is ripe for that, it would not surprise you, would it?

Mr. DEMPSEY. It would not surprise me if the case were appealed?

Senator ROCKEFELLER. Yes.

Mr. DEMPSEY. Well, I must say that I am not familiar with the case.

Senator ROCKEFELLER. I understand. I do not mean to press you on that.

Does the different rate reasonable test articulated in that case, if you are in a position to answer this, different from the commodity grains, sit well with your members?

Mr. DEMPSEY. I am sorry, Senator.

Senator ROCKEFELLER. You are not able to answer that?

Mr. DEMPSEY. I would be glad to look into it and advise you on that, as to what our views are.

Senator **Rockefeller**. I appreciate that very much, Mr. Chairman.

[The material referred to follows:]

Senator Rockefeller has asked whether the rate reasonableness test articulated in a recent Commission decision (*McCarty Farms et al.* v. *Burlington Northern, Inc.*) "sit well" with AAR members. In response to Senator Rockefeller's inquiry, I wish to state that the railroad industry views the rate reasonableness test articulated in the McCarty Farms decision as wholly lacking in economic foundation and as arbitrary in the extreme.

Essentially, what the Commission did in McCarty Farms was to calculate an average revenue/variable cost ratio for allegedly comparable "captive" grain traffic carried by all railroads and use such as average revenue/variable cost ratio as a maximum rate constraint for the Burlington Northern grain traffic at issue. The test as formulated by the Commission is riddled with both irrational assumptions (e.g., it assumes that all traffic above the Commission's jurisdictional theshold is "captive") and theoretical inconsistencies (e.g., application of an average revenue/variable cost ratio to determine a maximum reasonable rate is ultimately self-defeating; the test arbitrarily assigns to unreasonable status the approximately one-half of movements above the average). The test also wholly ignores the revenue needs of the railroad industry. Indeed, the test assumes without foundation that the existing aggregate level of railroad industry revenues is already adequate.

Moreover, the test was applied by the Commission in McCarty Farms without the benefit of prior public comment (it is currently the subject of a pending rulemaking proceeding) and in the absence of an evidentiary record in the McCarty Farms case itself with respect to the rate reasonableness issue (the parties had only submitted evidence on the market dominance issue at the current stage of the proceeding). Indeed, the Commission itself recognized the ad hoc and interim nature of its maximum reasonableness decision in McCarty Farms by specifically inviting the parties to that proceeding to submit additional comments on the rate reasonableness issue. Based on public comment in the rulemaking proceeding and a full evidentiary record on the rate reasonableness issue in the McCarty Farms case, the railroad industry is hopeful that the Commission will reject the arbitrary revenue/variable cost test applied on an interim basis in McCarty Farms and adopt maximum rate reasonableness guidelines for non-coal traffic on rational economic principles consistent with those underlying its constrained market pricing guidelines for coal traffic.

Senator **Rockefeller**. I am not able to pursue that line of questioning, so I will pass.

Senator **Exon**. Thank you, Senator Rockefeller.

Gentlemen, thank you very much, Mr. Briggs, Mr. Dempsey, and Mr. Hughes. We appreciate very much your taking the time to come here and give us this important testimony this afternoon.

You are excused.

Mr. **Dempsey**. Thank you very much, Mr. Chairman.

Senator **Exon**. We will now call our next panel: Mr. James Voytko, Vice President of Paine Webber; and Dr. Mark Cooper, Director of Research for the Consumer Federation of America.

Gentlemen, if you will come forward. And while you are coming forward, I must go to the floor for a few minutes. Senator Rockefeller has agreed to chair the meeting, and I will be back shortly. If you will proceed at this time. Mr. Voytko, we will start out with you.

STATEMENTS OF JAMES M. VOYTKO, FIRST VICE PRESIDENT, PAINE WEBBER, INC.; AND DR. MARK N. COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA

Mr. **Voytko**. Thank you very much, Mr. Chairman. Good afternoon, Mr. Chairman and committee members.

My name is Jim Voytko and I am the rail equity analyst for Paine Webber in New York City. I appreciate your invitation to testify today and my comments, as always, are my own.

Economic regulation invites what I call the "angels dancing on the head of a pin" syndrome. So entranced do we become in the case of the railroads by technical variations, sometimes important, often not, in the definition of revenue adequacy or the optimal trigger for maximum coal rate regulation that we ignore the larger, more important picture.

The salient features of that larger picture are these five in my opinion:

First, that railroading is not a financially rewarding business at present. It offers low returns, minimal growth prospects, very competitive pricing, shrinking market share, and serious regulatory and financial uncertainty for managers and shareholders.

Thet financial uncertainty is probably most pointedly shown by the problems apparent in the rail retirement fund. The regulatory uncertainty is adequately demonstrated by this hearing today. In fact, in comparison to the Rail Labor Act, the ink is still scarcely dry on the Staggers Act and the Congress is already talking about a major restructuring of that legislation.

I believe one of the Committee members mentioned earlier that the Staggers Act is probably ripe for review. If that is so after just a few years, how much more ripe for review must be the Rail Labor Act?

The second salient feature is that rail managements are withdrawing assets from the industry at what I think is an accelerating pace. In the seventies that took place through bankruptcy. In the eighties this is taking place through the more controlled means of abandonments, line sales, and the investment of funds outside of the railroad business. There are many examples of each.

The third point is that nearly all the forces in my view spurring the rapid contraction of the rail industry which can be influenced by changes in public policy—and that is the key point—can be traced to a set of problems linked to rail labor and Federal law: namely, the Rail Labor Act, secondary boycotts, FELA, and rail retirement, to offer the most important examples.

Though I understand that this committee lacks exclusive jurisdiction in these areas, these problems are so serious that I believe they dwarf the handful of contested rate cases that have come up since the enactment of Staggers, no matter how hotly those cases have been debated.

The fourth point is that, viewed in this context, proposals to return to more restrictive economic regulation or to burden the transfer of lines to newly created regional railroads with labor protection, which I believe are bad ideas in their own right, become truly irrelevant to the real problems besetting the industry.

I think there is nothing worse than a bad idea, except one that is bad and irrelevant.

The fifth point is that the failure to act on these issues is really tantamount to opting for a continued withdrawal of assets, shrinkage of employment, and withdrawal of rail service in the industry—and this is the key point—perhaps to a greater degree than need be the case.

I would like to emphasize this last point. The rail system and rail employment in the U.S. will almost surely shrink further over the next five years. There is a real danger, however, that rail labor, management, shippers, and policymakers will react to this likelihood in a very passive manner, accepting those factors that have so strongly contributed to the decline of the U.S. rail system, especially those which can be influenced by changes in public policy.

It would be all too easy for the Federal Government to passively sit out this consolidation and to avoid confronting the admittedly delicate question of putting rail labor negotiations back in the hands of labor and management. But after all, if the Rail Labor Act is so good, why do we not apply it to all industries?

It would be so easy to avoid redressing the bargaining imbalance which again, to use a phrase that Senator Rockefeller used earlier, the "incredible market power" caused by the extraordinary power of the secondary boycott. But again, if secondary boycotts are such a good idea in labor policy, why do they not apply to all industries?

It would be easy to avoid re-examining the wisdom of the truly extraordinary and expensive labor protection costs that are placed upon the railroad industry. Again, if labor protection payments are such a good idea, why not for all?

I think it would be easy to avoid finding a fair but less costly and far less litigious employee injury compensation system to replace FELA. Again, if FELA is so good, why do we not apply it to everyone?

And most importantly, finding a solution to the growing funding problem in Tier 2 of the rail retirement fund.

The passive approach is tempting because it is all too easy to look at a declining industry and say, well, it is going to decline, let us all just get out of it what we can. Who speaks, however, for the rail workers that hope to be employed in the future, and for the shippers that hope to get rail service in the future? I am not sure that they have a voice, either at this hearing or anywhere else.

The passive approach could easily lead to a decline in the rail system, the breadth of rail service it offers to shippers and rail employment that is greater than is made necessary by the lack of growth in the bulk commodity sector of the industry or trucking competition or anything else.

Given the unlikelihood of any new investment in railroading, any shrinkage in the rail plant that is caused by such things as additional economic regulation, such as I see envisaged in the CURE Act, is irreversible.

Let me end with a provocative comment, which is that this irreversibility is so significant when you consider it in the context of public policy that proposals like the CURE bill or labor protection for short lines, which might well end up forcing unnecessary abandonments, probably represent a bigger risk than even something as dramatic as the simultaneous abolition of the ICC and the Rail Labor Act. After all, regulation can be reinstituted far more easily than abandoned track can ever be rebuilt.

Thank you very much. I would be happy to answer any questions.

[The statement follows:]

STATEMENT OF JAMES M. VOYTKO, FIRST VICE PRESIDENT, PAINE WEBBER, INC.

Good morning Mr. Chairman and Committee Members. My name is Jim Voytko and I am a First Vice President and Rail Equity Analyst at Paine Webber, Inc., a larger full service brokerage and investment banking company in New York City. I appreciate your invitation to comment today on the financial status of the rail industry, it future prospects and some of the key factors which influence those prospects.

Economic regulations invites what I call the "angels on the head of a pin" syndrome. So entranced do we become in the case of the railroads by technical variations—sometimes important, sometimes not—in the definition of revenue adequacy or the optimal trigger for maximum coal rate regulations, that we ignore the larger picture. The salient features of that larger picture are these:

Railroading is not a financially rewarding business at present.

Rail managements are withdrawing assets from the industry at an accelerating pace.

Nearly all of the forces spurring the rapid contraction of the rail industry, which can be influenced by changes in public policy, can be traced to a set of problems linked to rail labor and Federal law: namely the Rail Labor Act, secondary boycotts, FELA and Rail Retirement.

Viewed in this context, proposals to return to more restrictive economic regulation or burden the transfer of lines to newly created regional rails with costly labor protection—bad ideas in their own right—become irrelevant to the real problems besetting the rail industry.

Failure to act on these issues is tantamount to opting for a continued withdrawal of assets, jobs and service from the industry—perhaps to a greater degree than need be the case.

It is the last point I would like to emphasize. The rail system and rail employment in the U.S. will almost surely shrink further over the next five years. There is a real danger, however, that rail labor, management, shippers and policymakers, will react to this likelihood by continuing to passively accept those factors which have so mightily contributed to the decline of the U.S. rail system especially those which can be influenced by changes in public policy. It would be all too easy for the Federal Government to passively sit out this consolidation, to avoid confronting the need to:

put rail labor negotiations back in the hands of labor and management in hopes that the two most affected parties can work to reconcile compensation and labor productivity with the industry's fundamental financial prospects.

redress the bargaining imbalance caused by the extraordinary power of the secondary boycott.

reexamine the wisdom the truly extraordinary (and expensive) labor protection costs assocaited with New York Dock.

resolve labor issues in a manner which maximizes economically sustainable employment, compensation and rail service while minimizing unnecessary route abandonments (which serve no one's interest) and the transition difficulties of rail workers who may be displaced.

find a fair but less costly and less litigious employee injury compensation system to replace FELA.

find a solution to the growing funding problem in Tier 2 of the Rail Retirement fund.

protect the industry's ability to place light density or otherwise uneconomic trackage in the hands of lower cost, more locally responsive shortline railroads to prevent unnecessary abandonment of service.

This passive approach could easily lead to a decline in the U.S. rail system, the breadth of rail service offered to shippers and total rail employment *that is greater than is made necessary* by external factors such as intense trucking competition or a lack of growth in the bulk commodities sector of the economy. Moreover, such a scenario worsens still further the outlook for rail retirement funding deficits and may lead holding companies to segregate non-rail assets to protect them from our current follies leaving an even slimmer set of resources available to solve this problem. Given the unlikelihood of any new investment in railroading, shrinkage in the rail plant once it has taken place is probably irreversible. Hence public policy proposals like the CURE bill and labor protection for shortlines which would likely spur further retrenchment represent a bigger risk than even something as dramatic as abolition of the ICC and the RLA. Regulation can be reinstituted more easily than abandoned track can be rebuilt.

THE FINANCIAL STATUS OF THE RAIL INDUSTRY

While debates rage about the most appropriate methodology for calculating rail return or investment on how fast the Interstate Commerce Commission should decide cases, I believe most analysts of the industry would agree that the broad picture of the rail industry would include the following:

Shrinking market share—down an additional 3½ percentage points since 1980;

Declining real prices—down 5.1% since 1980;

A shrinking physical plant—down nearly 10% since 1980;

Clear signs of declining rates of reinvestment;

Inadequate returns on investment (ROI);

Higher than average labor costs—45% higher than the average for U.S. manufacturing;

Unnecessarily low labor productivity—major companies report thousands of unnecessary employees;

Abnormally expensive retirement and employee injury compensation systems;

Vigorous external competitors lacking most of these problems; and

An ever present threat of a return to more restrictive economic regulation.

If this brief description of the industry sounds grim, I can only wonder how much worse it would be had the Congress not passed the Staggers Act in 1980.

But is this a selective rendition of the industry's characteristics? The behavior of two key groups—rail management and the stock market—suggest otherwise. The managements are clearly orchestrating an across the board reduction in their companies' exposure to the rail business through abandonments, track sales, layoffs and new investments outside the industry. These are clear indications that they see little financial reason to increase their involvement in railroading—at least in its current state—versus other opportunities.

There is little in the stock market's recent appraisal of railroad stocks to suggest any widespread belief that the industry is financially robust.

Railroad stocks have not kept pace with the market since 1980 (see Table 1). Rail price/earnings and price/book value ratios lag that of the market, often substantially (see Charts 1 and 2). Moreover, there is evidence that were the rail operations of these rail holding companies trading independently of the non-rail assets, the market's valuation of railroad earnings and assets would be even lower. This is suggested by the fairly strong inverse correlation between P/E and P/B and the degree of dependence on railroading in the parent company (see Table 2). In other words, the more a company looks like a railroad, the lower the market's valuation. All this suggests a distinctly pessimistic view of the financial prospects of the rail industry.

TABLE 1.—S&P RAIL STOCK INDEX VERSUS S&P 400 INDEX

	S&P rail stock index	Percent change	S&P 400 stock index	Percent change
Dec. 31, 1979	56.50		121.02	
Dec. 31, 1980	107.00	89.4	154.45	27.6
Dec. 31, 1981	88.87	−16.9	137.12	−11.2
Dec. 31, 1982	86.15	−3.1	156.62	14.2
Dec. 31, 1983	115.83	34.5	186.24	18.9
Dec. 31, 1984	105.03	−9.3	186.36	.1
Dec. 31, 1985	141.16	34.4	234.56	25.9
Dec. 31, 1986	136.05	−3.6	269.23	14.8
Dec. 31, 1980 through 1986		27.1		74.3

TABLE 2.—RAIL COMPARISONS

	Rail revenue as percent of total	P/E 1987E [1]	Price/book
Conrail	100.0	9.7	0.634
Sco Line [2]	100.0	nmf	0.648
CNW Corp	95.4	9.5	1.195
Norfolk Southern	81.6	11.9	1.106
Santa Fe So Pac	75.1	20.2	1.369
CSX Corp	72.1	12.4	1.032
Kansas City Southern	65.8	28.9	1.380

TABLE 2.—RAIL COMPARISONS—Continued

	Rail revenue as percent of total	P/E 1987E [1]	Price/book
Burlington Northern	54.8	15.9	1.441
Union Pacific	53.0	14.4	2.179

[1] All estimates except for Soo Line and Kansas City Southern from Paine Webber research. Stock prices as of June 2, 1987.

[2] Soo Line is expected by I.B.E.S. to be only marginally profitable in 1987.

CHART 1
Price/Earnings

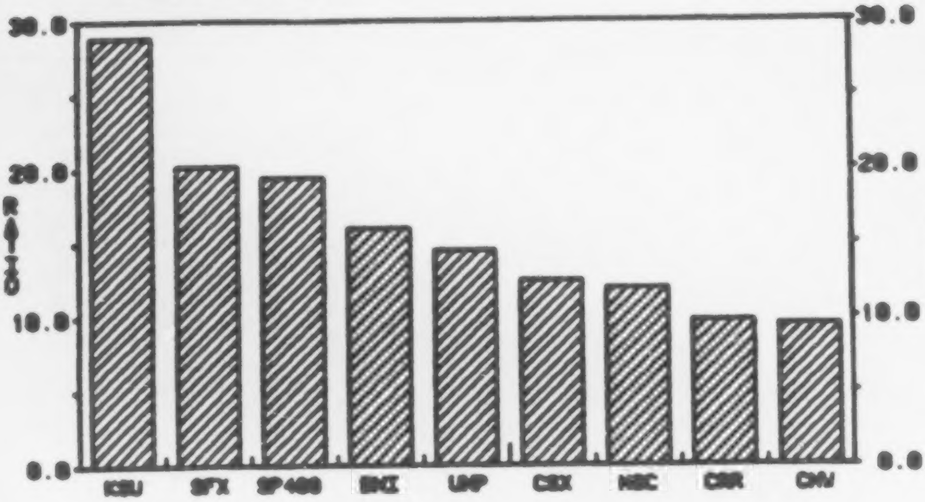
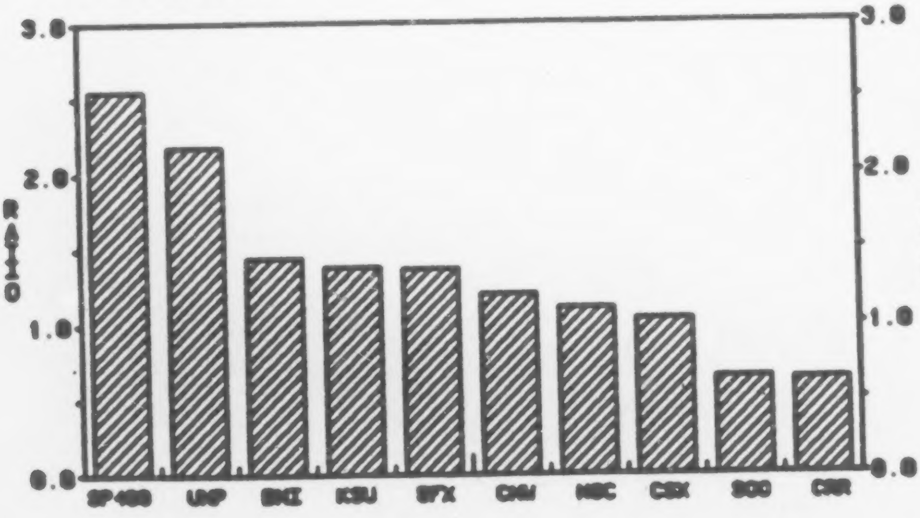


CHART 2
Price/Book



WHY THEN DO SOME SEE RAILROADING AS FINANCIALLY REWARDING?

From time to time I encounter the arguments made by those who would have us see the rails as so financially strong, so unfettered by competition that Congress must saddle the industry with additional regulatory and financial burdens.

For example, the rails must be well off because:

They are acquiring substantial non-rail assets.—If ever there was a clear indicator that rail managements and stockholders see relatively bleak prospects for new investment in the rail business, it is the persistent movement of stockholders' funds into non-rail businesses. To an analyst the non-rail acquisitions by Burlington Northern, Union Pacific, CSX, Norfolk Southern and Chicago Northwestern to name a few suggest a pervasive trend to place incremental funds outside the rail industry, away from the low ROI's, minimal growth prospects and intense labor cost pressures present in railroading.

The rails are earning monopoly profits from captive shippers.—My only comment as a rail securities analyst is where exactly are these monopoly profits? The ICC ROI figures show no evidence of any pervasive above average returns. Nor do the earnings reports of the individual railroads I analyze. Moreover, the collapse of rail rates and margins in the huge western coal market or the decline in the once promising eastern export coal market fail to suggest an inherent ability to earn monopoly profits. Instances of monopolistic returns must be rare since they seem difficult to find in significant micro-markets and in any case are not large enough in the aggregate to significantly improve the rails overall financial performance.

Rail cash flows are strong.—With the one-time benefits of the frozen asset base writedown behind them and the increased tax liabilities created by the recent tax reform legislation upon them, the major opportunity for the rails to boost cash flow over the next few years is through continued declines in capital spending on the rail plant and continued liqudation of portions of the rail plant. Cash flows from these unappetizing sources are hardly the basis for a declaration of sound financial health.

The rails have profitable and/or valuable non-rail assets.—So what? Would we punitively regulate the earnings of the chemical industry because Dupont owns oil and gas assets? Would we insist that General Motors liquidate its data processing operations because it owns an auto company? An examination of rail financial prospects and rail public policy issues should stick to matters relevant to railroading.

Finally to those who think the rail business is so profitable, I offer the following thought experiment. If you could (legally of course) buy as much CSX stock as you wished the day before you knew the company was to announce plans to borrow funds and construct an all new multi-billion dollar rail line from Chicago to Los Angeles, how much would you buy? Enough said.

REREGULATION: DOES IT EVEN ADDRESS THE REAL PROBLEMS?

I continue to be surprise by the primary thrust of rail policy debates, especially the view that proposals such as those embodied in the CURE legislation have anything to do with the real problems besetting the rail industry causing a continuing cascade of abandonments and capital spending reductions.

For example:

How would competitive access give the rails any greater opportunity to make returns high enough to justify reinvestment in their plant much less any new additions to the U.S. rail system? It wouldn't. It would almost certainly accelerate that decline (as well as deal a severe blow to our belief in property rights).

How would placing labor protection burdens on the transfer of light density or low ROI lines to eager shortline entrepreneurs reduce the punitively high labor costs (and distressing low labor productivity) of the rial industry? It wouldn't. It would probably condemn more light density lines to abandonment or reduced investment service. What are opponents of shortline sales afraind of? Could they be concerned that some of these new operations might so convincingly demonstrate that the real problems sapping the vitality of the rail industry are the exceedingly high labor costs and low productivity destructively embedded in the industry's current labor agreements and that all parties involved, including rail shippers and policy makers, might turn their attention to reforming these agreements? Increasing experience with more rational labor agreements such as those present on many of the new and proposed shortlines might just show that the rails are more formidable competitors for the right to serve intercity freight shippers than the traffic history of the last several decades would suggest.

How would shifting the burden of rate reasonableness and possibly capping rates encourage rail managements and stockholders to reinvest funds back into the national rail system and aid their ability to attract those funds in the capital markets? It wouldn't.

How would solving rail retirement's longterm financial problem solely with still further increases in company and worker contributions help either group? It wouldn't. Rail retirement deficits are more likely to be solved by better rail financial performance and direct negotiation of potential solutions between management and labor.

WHAT THEN ARE THE REAL ISSUES?

If adding new regulatory restrictions to the rail business aren't even relevant, what is? My comment on this question is as follows. The railroads nor any other industry "deserves" any profit whatsoever. Nor do they deserve any shield from legitimate competition no matter what the source—trucks, barges, slurry pipelines or clever shippers who know how to bargain over rates effectively. They do, however, deserve to compete for business without any special and unnecessary disadvantages. It is these special "handicaps" which lie at the heart of that portion of the rails' competitive and financial problems which can be affected by appropriate changes in public policy. For example:

Why must rails almost alone among U.S. industries be subject to the incredible power of the secondary boycott? This power has and continued to be a critical ingredient in the unhappy constellation of events which over time has led to the serious problems of high wage levels but low returns, overstaffing but limited control of personnel levels and restrictive work rules which prevent realistic productivity gains from benefiting shippers and rail stockholders. If permitting secondary boycotts is such a great idea, why doesn't it apply to all of U.S. industry?

Why can't railroads conduct their own contract negotiations as other industries do without the seemingly inevitable intervention of the Federal government? The rail industry (and alas by derivation the rail analyst) is no longer so vital to the U.S. economy as was the case when the Rail Labor Act was passed. If the procedures in place under the Rail Labor Act are so good, why aren't they applied to all other industries?

Why must the rail industry use an expensive, trial-based, litigation driven system like FELA for compensating injured employees? If FELA is such a great system, why doesn't it apply to all other industries in the U.S?

Why must the rail industry be continually at regulatory risk despite its modest financial performance and prospects? Some of those present today, even those who believe the rails are sufficiently sound financially to bear greater regulatory burdens, may have had cereal for breakfast this morning, made and sold to them by companies which quite likely have ROI's considerably higher than the railroads. They may have watched a few minutes of an early news program brought to them courtesy of a collection of media companies and powered by one or more electric utilities all of which quite likely have higher ROI's than the railroads. Some of them may have smoked a cigarette made and sold to them by companies with ROI's quite likely considerably higher than the railroads. I suspect few if any of these individuals were consumed with concern over the profitability of the companies they did business with this morning. Imagine the attention the rail industry would get if it merely earned returns equal to those industries whose profitability we contribute to with little question every day?

PAST REREGULATION TO RAIL LABOR REFORM

Obviously, I feel the most pressing issue for rail managements, stockholders, workers and shippers is not the re-establishment of more restrictive economic regulation, but rather the consideration of policy reforms which allow the rails to be as efficient as possible. Then at least we can be sure that whatever rail plant is retained, whatever profits the industry does or doesn't make, whatever market share the rails manage to earn, it is the best we can hope for and the "right" amount. This re-examination of rail policy must center on seven key areas all of which, of necessity, involve labor.

I do not pretend to have glib solutions ready for such serious problems. I do know that the ability of the rail industry to improve its financial health, lower the costs of rail service to shippers and provide secure employment for the workers needed to operate the system depends on our putting aside the irrelevant and ultimately self destructive proposals to reregulate the industry and get to work on these problems.

Whether the Congress chooses to tackle this task through a blue ribbon panel, further hearings or the entertainment of proposals generated by the Administration, the industry or labor matters less than the key decision to address them soon.

It seems to me that any of the interested parties—labor, management, shippers or rail policymakers—which opts not to act on these problems opts by default for more of the same—further shrinkage of the rail system, fewer jobs, lost opportunties to lower rail rates and continued uncertainty over the funding for rail retirees. With this failure to act will come a haunting concern that perhaps these declines were steeper, the costs greater, the rates higher, the lost business larger than they had to be if we had only made the effort, however difficult, to find and implement solutions. It is particularly puzzling to me why shippers, who have so much to gain from more rational labor arrangements and a more efficient cost structure in the rail industry, are not leading the charge on these issues.

Thank you again, Mr. Chairman and Committee Members for the opportunity to testify today. I would be happy to answer any questions you might have.

[The following information was subsequently received for the record:]

Questions of the Chairman and the Answers

Question. You have testified regarding the numerous problems facing the rail industry. In light of this, how do you explain the apparent eagerness of investors to put money into the Conrail, a pure rail operation of the type you generally describe in less than favorable terms?

Answer. "Eager" is not a very specific term. In the securities markets (as in all markets) price acts as the great equalizer. Conrail was offered and still sells at a substantial discount to the market using frequently employed ratios such as price to earnings and price to book. If Conrail had been offered to investors at the same price levles (relative to earnings, book value and cash flow) as the broad market, it is unlikely investors would have eager to own the stock. Moreover, it is my opinion that if investors had been told that Congress was to enact the CURE measures less than a year after that same body authorized the sale of Conrail stock to the public, investor interest would have been substantially diminished (and Conrail's valuation as well). Those of a more cynical nature might wonder why the Conrail sale preceded a clearcut Congressional decision on the merits/demerits of the CURE proposals. Finally, I believe a portion of the optimism some investors hold for Conrail in the longrun in fact relates to a hope that Conrail *will be less of a railroad* in the future—i.e., its cash flow will be invested outside the rail industry.

Question. Do you have an opinion as to the extent to which captive traffic is a factor in railroad profitability? Can you express an opinion as to the extent to which captive traffic might subsidize competitive railroad traffic?

Answer. As everyone familiar with railroad cost allocation and traffic segment profitability knows, there is a great deal of uncertainty assessing the degree to which segments contribute to aggregate rail earnings. I have no doubt that a railroad's pricing power varies over its customer base from those with numerous alternatives, service requirements difficult for rails to meet and generally little at stake should rail service disappear to those with fewer economic alternatives, service requirements especially suited to the rails and with a major stake in the preservation of rail service.

As to the issue of cross-subsidization, I cannot offer anything definitive except to say that I know of no rail management which has ever entered into a rail service segment assuming it would lose money but that these shortfalls would simply be made up by profits made elsewhere. The decline in the rail's pricing power across the entire traffic spectrum thus far with the competitive reforms instituted in the Staggers Act have made this a losing business strategy. Given geographic competition, product competition and more ingenious exploitation of inter and intramodal competition by shippers, the notion of trying to rob Peter to pay Paul doesn't strike me as an intelligent idea at all.

On numerous occasions, however, I have discussed new rail service ventures with managements where the express intent was to garner incremental revenues so as to make an additional contribution to the fixed costs necessary to service "traditional" rail customers and thus lower aggregate unit costs in the system. In many of these cases the catalyst was not the availability of "excess profits" but rather the opportunity to use reduced crew sizes or new technology like the Roadrailer or doublestack trains.

Question. Please elaborate on the impact you feel passage of the Consumer Rail Equity Act may have on the financial well-being of the rail industry.

Answer. There is no doubt in my mind that the aggregate effect of the CURE proposals on the financial health of the rail industry would be negative. Additional restrictions on maximum rates would limit the rails' ability to improve returns while competitive access would likely put extreme pressure on rates and the viability of weaker railroads and inject enormous uncertainty in the capital spending/replacement planning of the industry. I am not suggesting the inevitable result is bankruptcy for the industry. What I am saying with considerable conviction is that if the Congress follows a two-part program of (1) imposition of the CURE proposals and (2) ignoring the railroad's grave labor cost and productivity problems which are in no small part the product of Federal legislation, the rails will be weakened considerably.

QUESTIONS OF SENATOR ROCKEFELLER AND THE ANSWERS

Question. You testified that you "keep a close eye" on the ICC's revenue adequacy determinations. Please provide us with a copy of any written report generated by you or by Paine Webber since 1980 analyzing the rail industry or a particular railroad in which the ICC's revenue adequacy findings are mentioned or discussed.

Answer. The ICC figures have come up on numerous occasions in discussions with company managements both in public and private meetings and among analysts and investors such as the roundtable discussions published by the Wall Street Transcipt. Paine Webber has not published reports analyzing the ICC reports per se for several reasons. First, the focus of investors is always on the holding company because its aggregate earnings and assets are the fundamental substance underlying the securities which we buy and sell. Second, while analysts normally spend a great deal of time forecasting earnings by segment, the returns on specific asset segments are so detailed and so dependent on information not usually available when earnings are made public, that forecasting these segments returns is rendered less useful for our specific purposes. On the subject of ICC ROI, I have enclosed [1] a submission I was asked to make to the Commission on the appropriate measures to use in determining revenue adequacy. This continues to represent my views on the matter and, to the best of knowledge, that of most economists.

Question. Were you employed by the ICC? If so, please give the date of your employment and a statement of your responsibilities, including whether you contributed to the development of any of the ICC's post-Staggers Act standards.

Answer. Yes. I was employed by the ICC from 1979 to early 1981 serving directly in the Chairman's office. My responsibilities were broad, advising the Chairman on matters of all sorts before the ICC, working on legislative initiatives, and proceedings, external relations, overall policy studies and administrative matters. As I resigned from the ICC shortly after the passage of the Staggers Act, I did not play a role in any decisions regarding the implementation of the Staggers Act occurring after the spring of 1981. Whether any of my activities prior to my departure influences subsequent decisions by the Commission in this area, I have no idea.

Senator **ROCKEFELLER** (presiding). Thank you, Mr. Voytko.

Before we go to Dr. Mark Cooper, while Mr. Dempsey is still here, Mr. Dempsey, might I ask, both Senator Pressler and in my own case also we had questions that we wanted to submit. There are other hearings that are coming up, obviously, which will have an effect on this also. Would it be possible for you to be able to respond to our questions within a seven day period?

Mr. **DEMPSEY**. Oh, yes, surely.

Senator **ROCKEFELLER**. I appreciate that very much.

Dr. Mark Cooper.

Dr. **COOPER**. Thank you, Senator Rockefeller.

We believe now, as we have in the past, that the Staggers Act is an excellent piece of legislation, but certain of its most crucial provisions have been butchered by the ICC. Last year the Chairwoman of the ICC told this committee that the revenue adequacy test was incorrect. Two weeks earlier she had told the House that it was correct.

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[1] The enclosure was not reproducible.

Last week she made the claim that it just does not matter. I wait to see what she will say when she comes to this side.

In the process of making her latest claim, the ICC asserts that the revenue adequacy test is at best a useful indicator and that, although some railroads are financially sound, none are revenue adequate by anyone's standard. We disagree on both counts.

We believe that the revenue adequacy test is very important and that, by a reasonable standard, some railroads have been or are revenue adequate.

The FRA, the ICC, and the AAR have compared the rail industry to other large corporations, oil industries or the Business Week 1000. Now, that is a legitimate exercise in the context of assessing the ability to raise capital, which is what the Staggers Act said. It did not say anything about a specific revenue adequacy test.

However, the rail industry as such does not raise capital in money markets. Individual railroads and rail holding companies do. So it is much more appropriate to compare individual firms with the general performance of other businesses.

Let us look at two of the so-called revenue inadequate rail systems, the BN and the Norfolk Southern, which account for almost half of all coal rail revenues and over half of all rail incomes. They are relevant in that respect. For the period since the Staggers Act, these two rail systems have had a higher return on equity than the FRA's all-industry average, almost a full percentage point higher for the five years since the passage of the Staggers Act when they had the calculations from the ICC.

Not only did they earn a higher return on equity, but the amount of their equity grew almost one and a half times as fast as the equity in all manufacturing firms, and it was funded by retained earnings. So they did not even have to go to the capital markets.

Their profit margins and bond ratings are much higher than the average for the other large corporations on the ICC's list of 1,000. Their debt is smaller as a percentage of assets and consequently the fixed charge and coverage ratios are much better.

The rail operations of these two corporations have performed excellently. Therefore, it is absurd to argue that the billions of dollars invested in non-rail assets by these two entities since the passage of the Staggers Act reflects a flight of capital from economic activities that are not adequately rewarding.

On the contrary, these two railroads have invested as much as they reasonably could in rail operations. They have built their equity as fast as they reasonably could. They have reduced their debt below that of other large corporations, and they still have cash left over. And believe me, they did not write a check on the treasury; they collected that money from ratepayers, consumers who use the system.

This is not capital fleeing an industry that is unremunerative. It is capital spilling out of lines of business that are saturated with returns.

Yet these two corporations, these two rail systems, which outperformed other major businesses on virtually every indicator used by financial analysts, are deemed to be grossly revenue inadequate by the ICC. They earned about $4 billion. The ICC says that they needed to earn $8 billion since the passage of the Staggers Act.

I leave it to your imagination to fathom what they would have done with the extra $4 billion. I assure you, it could not possibly have gone into rail operations.

Now, how could the ICC go so far astray? The answer is simple: The revenue adequacy test is wrong in its fundamentals. We are not objecting to the concept of the current cost of capital, but how it is measured.

First, the target return on equity is much too high. For the period since the Staggers Act, the ICC has set a target return on equity that is over six percentage points higher than all manufacturing and four percentage points higher than the Business Week 1,000.

For the five years since the passage of the Staggers Act, 700 of the largest 1,000 corporations in the nation failed to achieve the target return on equity. If you go down the list of business groups presented by the ICC to the House, only one industry hit the target rate of return in all five years, and one hit it in four years. Twenty-five failed to hit it even once.

This is not a standard of revenue adequacy; it is a standard of revenue excess.

Now, the consumer movement has been actively involved in this issue for a simple reason. We pay the bill. Coal rates are passed directly through to consumers in fuel adjustment clauses.

Now, it is possible to be above 180 and not be captive, but we believe we account for the bulk of that 100 percent of profit which is made for the rail industry above 180. We understand and accept the concept of differential pricing for railroads. That is why we have never proposed to lower the jurisdictional threshold.

But we do not accept the massive fictitious revenue requirement that the ICC has concocted in the past half decade. Nor do we believe that Congress expected 15 or 20 percent of all rail traffic to account for 100 percent of profits.

If we are to be the captives and bear the bulk of the burden of rail profitability, we ask for a reasonable estimate of how heavy that burden has to be and a fair allocation of the burden among all shippers.

Thank you.

[The statement follows:]

STATEMENT OF DR. MARK N. COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA

Mr. Chairman and Members of the Committee, my name is Dr. Mark N. Cooper. I am Director of Research of the Consumer Federation of America with offices at 1424 16th Street, N.W., Washington, D.C. 20036.

THE CONSUMER FEDERATION OF AMERICA

The Consumer Federation of America (CFA), founded in 1968, is the nation's largest consumer advocacy organization. CFA's membership encompasses more than 200 national, state and local consumer, senior citizen, low-income, union, farm, labor, public power and cooperative organizations representing more than 35 million people.

I appreciate the opportunity to testify before the committee today. The Consumer Federation has testified several times before both the 98th and 99th Congresses on a number of aspects of the Interstate Commerce Commission's (ICC) implementation of the Staggers Rail Act of 1980. In addition, we have testified and participated in proceedings at the ICC.

We believe now, as we have throughout our involvement in this issue, that the Staggers Act is an excellent piece of legislation, but certain of its most crucial provisions have been butchered by the Interstate Commerce Commission. Unfortunately, in the four years since we first testified before the Committee, the ICC has done virtually nothing to diminish the bloodletting. Only Congress can repair the damage by enacting the Consumer Rail Equity Act.

In the current series of hearings, the Committee has heard from others about the procedural nightmare at the ICC and about specific cases in which shippers and consumers have paid millions in excessive rates as a result of the inaction and unfairness of the ICC. In my remarks today I will focus on a narrow set of fundamental issues—the revenue adequacy or financial health of specific railroads, how it relates to market power in the rail industry and why the consumer movement cares so much about these matters.

ASSESSING FINANCIAL PERFORMANCE

Real firms versus industry averages.—Although the ICC and the AAR frequently speak about the rail industry in the aggregate or on average, financial analysts do not look at, and individual investors do not put their money in, the aggregate industry. They invest in specific corporations.

Within any industry there will be large differences between firms. They differ in their management, their economic circumstances, their financial obligations, and their stock of plants and equipment, to name just a few of the factors that have a tremendous impact on the corporate bottom line. The condition of the overall industry will be one consideration in an investor's decision about where to invest, but the characteristics, performance and prospects of the individual firms will have far more weight in the ultimate decision.

Indicators of financial performance.—Analysts generally examine a variety of indicators to assess the performance of firms. A recent analysis conducted by the Government Accounting Office (GAO) identified five different categories of indicators—rates of return, earnings, cash flow, operating ratio and financial ratios.[1] Financial ratios were the most frequently used, being relied upon by all eight of the financial analysts surveyed. This was followed closely by rates of return (seven of eight) and cash flow (six of eight). Earnings and operating ratio were examined by five of the eight.

Of course, financial analysts differ in their opinion of exactly which indicators are most important. Therefore, I have reviewed a very broad range of indicators. Moreover, since the purpose of determining the revenue adequacy of the railroads is to assess their ability to attract investors in the nation's capital markets, I have also included comparable indicators for the nation's manufacturing sector and largest corporations.

The financial indicators that I present in my testimony are not only the ones used by most financial analysts, they are also virtually identical to those proposed and used by Conrail to assess the financial soundness and long term viability of the P&LE and Guilford Railroads, which were potential divestees in the Conrail/Norfolk Southern merger.[2]

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[1] The Government Accounting Office "Railroad Revenues: Analysis of Alternative Methods To Measure Revenue Adequacy," October, 1986.

[2] Howard William Brown, Vice President and Treasurer of Conrail, testifying before the ICC "Reply Statement of Consolidated Conrail Corporation," June 7, 1985, put it as follows:divestitu

As a railroad financial officer, I am familiar with the financial criteria by which to assess the long-term viability of projected expansion of operations such as those proposed by Guilford Transportation Industries (Guilford) and the Pittsburgh and Lake Erie Railroad (P&LE). The purpose of this statement is to discuss these criteria and to provide some analysis of the proposed divestitures, as this study is the first formal opportunity for such an examination.

The financial criteria fall into three categories. The first category covers general financial factors that bear on the ability of a company to withstand financial downturns and support acquisition and capital programs.

Analysis of these factors require detailed historical financial data as well as financial projections and plans for financing. Second, are ratios based on investment and financial results, that measure financial health. Third, there are ratios indicating operating efficiency and productivity . . .

THE FINANCIAL PERFORMANCE OF THE BURLINGTON NORTHERN AND NORFOLK SOUTHERN rail systems

Two large, coal hauling rail systems.—a review of the financial performance of a number of major railroad systems shows clearly that they have been performing on a par with or better than the rest of the nation's large corporations for the past half decade. Two examples that are of special importance in the discussion of the implementation of the Staggers act are the Burlington Northern and the Norfolk Southern.[3]

In 1985, these two rail systems have accounted for more than one-half of the rail industry's net income (see Exhibit A-1).[4] They also accounted for almost half of all coal transported by rail (measured either by ton-miles or revenues). However, they account for just under 30 percent of rail industry assets. For the nation's electric utility consumers, they are at the center of the debate over revenue adequacy, monopoly power and captive shipper protections.

Return on equity and the internal build-up of equity.—In the five years since the passage of the Staggers Act, the average return on equity (ROE) earned by these two railroads exceeded the average ROE earned by all manufacturing corporations in the nation by about one percentage point (see Exhibits B-1 through B-4). It was between a half and one percentage point below the ROE earned by the Standard and Poors 400 or the Business Week 1000.

Not only has the return on equity been equal to that of other large corporations in the nation, but stockholders' equity in these railroads has been growing much faster than the equity in other corporations (see Exhibits B-5 and B-6). Between 1981 and 1985 stockholder equity in all manufacturing corporations grew at 5.3 percent per year. It grew at about 7.8 percent per year in the Burlington Northern and at about 10 percent per year in the Norfolk Southern.

The growth in stockholder equity has been overwhelmingly funded from one source—retained earnings (see Exhibits B-7 and B-8). These two systems increased their total equity by $2.8 billion since the passage of the Staggers Act. Approximately $2.4 billion (over 85 percent) was in the form of retained earnings. Earnings from operations have been the source of funds for increasing equity; they have not had to go out to capital markets.

Dept and capital structure.—As a result of this strong growth in equity, debt has been reduced as a percent of assets (see Exhibit C-1). In 1981, these two railroads carried debt equal to about one-quarter of assets. That declined in 1985 to about one-sixth. The average debt carried by the Business Week 1000 is equal to about one-third of assets (see Exhibit C-2).

Of equal importance is the fact that not only has debt declined as a percentage of the assets of these two systems, it has declined in absolute size as well (see Exhibit C-3). Since the passage of the Staggers Act, these railroads have reduced their indebtedness by almost half a billion dollars.

Financial ratios.—With rates of return on equity approximately equal to that of other corporations, with strong growth in equity and with declining debt, we would expect these corporations to have very strong financial ratios—the measures most frequently used by analysts to assess the performance of corporations.

The current ratio (current assets divided by current liabilities) and fixed charge ratio (net income plus interest expense divided by interest expense) are among the most frequently examined by financial analysts because they indicate the ability to repay debt and therefore the geneal flexibility of the firm to meet obligations. The higher the ratios, the better off the firm is—the more resources it has for meeting it obligations.

The current ratios of these two rail systems are around 2.0 (see Exhibit D-1). For other large corporations they average around 1.4. The fixed charge coverage of these two rail systems is about 10 (see Exhibit D-2). For other large corporations in the nation it averages only about 3.5.

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[3] Throughout this analysis textural reference is made to the Norfolk Southern rail system. As the mergers of recent years have concentrated the nations railroads into a small number of very large systems which operate as integrated entities (endeavoring for example, to create single system movements, see below, page 15, note 1) the fiction of separate component railroads has become impossible to maintain. The ICC has declared its intention to begin treating these systems as single entities for purposes of financial analysis and the railroads have begun to report some of their financial and operating data on a single system basis. Because the data has been generally available for component railroads in overall systems and is still most familiar to analysts in that form, I report the separate components where possible, but it is clearly the overall system that is the financial and economic entity of interest and the text reflects this fact.

[4] All of the exhibits have been retained in the Committee files.

The bond ratings of these two corporation are AA and have been A or better for a decade (see Exhibit D-3). In 1984, fewer than 100 of the 600 corporations for which *Business Week* reported bond ratings were AA or better. Thus, these railroads had higher ratings than approximately 85 percent of the largest corporations in the country.

Operating characteristics.—Underlying this strong financial performance one would expect to find strong operating characteristics. Once again, the expectations are met.

For example, these railroad systems had profit margins—net income as a percentage of total sales—of 12 percent or more in 1985 (see Exhibit E-1). All manufacturing corporations had profit margins of only 3.8 percent while the Business Week 1000 had margins of 4.8 percent.

In the period after the passage of the Staggers Act productivity growth (measured by output per employee hour) was up over 40 percent on the BN, but only 1.2 percent on the NS (see Exhibit E-2). The increase in productivity in non-farm business over this period was 6 percent per year.

Other measures of operating characteristics of the industry—operating ratios, transporation ratios, etc.—are difficult to compare to industries in general. The debate over the sale of Conrail provides a frame of reference, however.[5] The Burlington Northern and Norfolk Southern have extremely low ratios—indicating strong performance—largely because of their specialization in bulk commodities (see Exhibit E-3).

REVENUE INADEQUACY AT THE ICC

A distorted picture of railroad financial performance.—In summary, when we look at the financial performance of these two rail systems through the lens of the financial and operating statistics and indicators used by most analysts on Wall Street, we see a picture of excellent financial health. Every measure shows them performing as well as, and the vast majority show them performing better than, the nation's largest firms.

The ICC sees a completely different picture. Since the passage of the Staggers Act the ICC has never found any component of these two systems, or any other major class I railroads for that matter, to be revenue adequate. The ICC has concluded that these two systems have had a revenue shortfall of approximaterly $4 billion since the passage of the Staggres Act. How could the ICC reach such a conclusion when the financial indicators routinely looked at by analysts and investors send such a different signal?

The answer is simple, the ICC's revenue adequacy test is wrong in its fundamentals.

Its target return on equity is much too high.

It has used a fictitious cost of debt which ignores the actual obligations of the railroads.

It has allowed the railroads to improperly write up the value of their assets.

These errors in the ICC's pronouncement on the financial health of the railroads are so pervasive that the analysis is rendered useless and irrelevant for serious financial decisionmaking. Indeed, the irrelevance of the ICC analysis was recently underscored when financial markets ignored the ICC's assessment of the financial condition of Conrail during the sale of its stock to the public.

The investment bankers handling the sale never mentioned the fact that Conrail had been found to be revenue inadequate by the ICC, even though they are bound by law to make all relevant information known to the public. Investors paid a premium for the stock. Yet, according to the ICC's revenue adequacy test, Conrail had a revenue shortfall in the three years prior to the offering that was almost equal to the total price that investors were willing to pay for it. These investors obviously know something that the ICC does not.

The excessive target rate of return.—If investors had bothered to look, they would have noticed that the return on equity which the ICC uses in its revenue adequacy determination is much too high (see Exhibits F-1 and F-2). For the five years since the passage of the Staggers Act, the ICC has set the target return on equity at 6 percentage points higher than that achieved by all manufacturing corporations and almost 4.5 percenatage points higher than that achieved by the Business Week 1000 and the S&P 400.

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[5] In the first quarter of 1985 the operating ratio for Conrail (CR), was 94.2 percent while that of Norfolk Southern was 83 percent. In defending CR's economic viability (in spite of a relatively high operating ratio) Morgan Stanley pointed out that Morgan Stanley Proposal to Purchase the U.S. Government's 85% Interest in Conrail May 14, 1985, Section VII, p. 12). It is important to remember that Conrail's mix of business is more heavily oriented toward the competitive, noncoal (largely merchandise) traffic (83.4% in 1984), whereas Chessies merchandise traffic acccounted for 52% of revenues in 1984, and Norfolk Southern's 66%. However, the more profitable activity for Norfolk Southern is the coal business, because Norfolk Southern runs long unit coal trains downhill from big mines to tidewater port facilities.

To put this another way, over 700 of the 1000 corporations listed in the "Annual Review of American Industry" (January 1986) conducted by Forbes Magazine failed to meet the ICC's target return on Equity in the period between 1981 and 1985. Indeed, in every year for which the ICC has made a determination since the Staggers Act, approximately two thirds of the nation's largest 1000 corporations failed to achieve a return on equity equal to the target that the ICC had set for the railroads.

Every investor would love to have the corporations in which he or she owns stock hit the ICC's target every year, but they must know that levels so high are not sustainable. The ICC has not set a standard of revenue adequacy; it has set a standard of revenue excess.

Overstatement of debt cost and the investment base.—Focusing on return on equity helps to cut through the smoke and mirrows of the ICC's revenue adequacy test. Still, it is important to note the other ways in which the ICC has overstated the revenue needs of the railroads.

First, by allowing the railroads to write up their assets for items that had already been expensed, when converting from retirement-replacement-betterment account (RRB) to depreciation accounting, the ICC is allowing a double recovery. The sum of money involved is huge—as much as $7 billion in fictitious investment base—throwing the revenue adequacy test off by over $1 billion per year.

Second, instead of calculating actual debt obligations, as every other corporation entity, regulated and unregulated, in the nation does, the ICC applies the current cost of debt to all outstanding debt when computing the cost of capital. Thus, the ICC uses a fictitious cost of debt. These two accounting gimmicks have inflated the estimate of revenue needs of the railroads by billions of dollars.

Magnitude of the ICC's Overestimate of revenue needs.—Combining the excessive ROE target with the overstatement of debt costs and the investment base, we arrive at the ICC's conclusion that the BN and NS fell $4 billion short of revenue adequacy in the period since the passage of the Staggers Act (see Exhibits F-3 and F-4).

The magnitude of the ICC's misrepresentation of the financial performance of these two rail systems is amazing. According to the ICC, these two systems, which were widely recognized during the period as financially sound, would have had to about double their income in order to achieve revenue adequacy. In addition, to the almost $4 billion they earned, the ICC maintains that they needed another $4 billion.

MONOPOLY POWER IN THE RAILROAD INDUSTRY

Congressional Recognition of the danger of market power.—The failure of the Interstate Commerce Commission to properly assess the financial condition of specific railroads is a matter of considerable concern to consumers. This concern stems from the existence of monopoly power in the rail industry, how it is exercised by railroads and regulated by the ICC.

When Congress passed the Staggers Act in 1980, it freed the railroads to meet competition from truck and barge traffic where it existed. It also expected competition between railroads. At the same time, it recognized that there would be numerous instances where effective competition does not exist—where barge or truck transportation is lacking or economically unviable and where shippers are captive to a single railroad. In these instances it preserved the regulatory role of the ICC with provisions to protect captives and ensure competitive access.

For half a decade the ICC has largely ignored these provisions of the Act, while the railroad industry has insisted that few if any shippers are captive and that those who are have not been abused by the market power of the railroads. As the industry has become more and more concentrated and evidence on the abuse of market power has mounted, the ICC/railroad arguments have become increasingly more difficult to maintain.

The Congress does not have to simply accept the word of shippers and consumers on these matters—recent statements by the railroads underline the pervasive role of market power in the railroad industry. They reinforce the urgent need to effectively implement Congress' original intention to protect captive shippers and preserve competition through regulatory oversight.

A pervasive pattern of anti-competitive behavior.—The effort of Norfolk Southern to buy Conrail stimulated a shouting match between CSX, Conrail and Norfolk

Southern about market power in the East. CSX offered to swap access to its virtual monopoly over the lucrative Florida market for access to the markets dominated by Norfolk Southern in the Mid-Atlantic and Conrail's "rail monopoly over much of the traffic in the Northeast." [6] A particularly contentious point in the debate was the foreclosure of competitive access, with CSX charging that "Norfolk Southern and Conrail already have foreclosed competition on their respective systems." [7]

At the same time, the efforts of the Santa Fe (SF) to acquire the Southern Pacific revealed a high level corporate document (requested by the SF board of Directors and signed by the CEO) which made clear "management's perception that Santa Fe's goal must be to raise revenues by reducing intramodal competition.[8] The goal embodied "a rail monopoly at points in California and throughout the Southwest by greatly increasing the number of exclusively served points." [9] Not only did SF envision increasing its market power, but it attributed the superior performance of the Union Pacific (UP) to the fact that "UP enjoys a lesser degree of rail competition in much of its service territory." [10]

Market power and rail profits.—as if to underline the pervasive importance of monopoly power, the Association of American Railroads recently stated that all of the profits of the industry come from captive traffic. The AAR now maintains (we should say finally admits, since it had repeatedly downplayed the importance of captive traffic) that in 1985, if rates had been capped at a revenue to variable cost ratio of 180 percent (which is the jurisdictional threshold for defined as captive), then over $1.4 billion in rail profits would have been wiped out and the railroads would have registered a $77 million loss.[11]

Leaving aside the fact that no proposal has been made to cap rates at 180 percent, this admission is most revealing. Only 15 or 20 percent of all traffic moves at a revenue to variable cost ratio greater than 180 percent. In essence, this very small group of shippers is shouldering the entire burden of rail profitability. Back in the 1970s there was a fear that railroads would become the wards of the Federal government; it now appears that they have become the wards of the nation's captive shippers.

THE CONSUMER INTEREST IN A REASONABLE REVENUE ADEQUACY TEST

The stakes for consumers.—The consumer movement has actively sought to have the Interstate Commerce Commission effectively oversee the exercise of this monopoly power for a number of simple reasons.[12]

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[6] As CSX put it "*Comments of CSX Corporation Concerning the Competitive Viability of Guilford Transportation Industries, Inc. and Lake Erie Railroad Company as Proposed Divestees,*" (May 24, 1985, pp. 55-56). Conrail posesses a rail monopoly over much of the rail traffic in the Northeast. For example Conrail originates and terminates approximately 99% of all rail traffic in the New York City/Northern New Jersey area and approximately 95% of all rail traffic in the Philadelphia/Southern New Jersey area . . . Conrail also is the sole rail carrier in three Massachusetts counties and one heavily industrialized county in Connecticut.

[7] Ibid., p. 66. The comments went on to give a relevant case in point.

For example, after the combination of Norfolk & Western and Southern Railway in 1982, Norfolk Southern began to require the exclusive use of its own routes for paper industry shipments by captive shippers (or to captive destinations) whenever it served both origin and destination points.

[8] ICC, "*Finance Docket No. 30400,*" et al., decision issued October 10, 1986, pp. 83.

[9] Ibid., p. 83

[10] Ibid., p. 86.

The exercise of market power by the Burlington Northern in the Powder River Basin has long been a subject of regulatory and policy concern. A draft report prepared by the Department of Interior concluded that "the historical weakness in competition for transporting PRB and other Western coal to market" had the following negative effects (Bureau of Land Management, "The Relationship Between Coal Transportation Competition and The Federal Coal Program," Draft Report, March 17, 1986, Exhibit I.b)

Consuemrs pay higher total delivered prices for coal; producers may receive lower prices for their mined coal;

Less western coal is produced and consumed than would be optimal from the standpoint of society and the regional production pattern may be inefficient.

The report identified "monopolistic pricing" that had cost consumer and producers as much as $160 million per year.

[11] On Track, Vol. 1, No. 3. If rates had been capped at 180 percent in 1985, every last penny of the railroad industry's $1.4 billion operating income would have been wiped out; and the industry would have been left with a $77 million deficit.

[12] In addition to the activities of the Consumer Federation of America, other public interest and consumer groups that have been active on this issue include the Consumer Energy Council of America, the National Association of State Utility Consumer Advocates, the National Association of Regulatory Utility Commissioners, the National League of Cities, and the U.S. Conference of Mayors.

First, as part of the nation's efforts to increase its energy security, a conscious program has been pursued to expand the use of coal, which is a domestic energy source available in virtually inexhaustible supply. Coal is now the dominant source of power for generating electricity in this country, accounting for 55 percent of the total (see Exhibit G-1). Hydroelectric power is a distant second with only 14 percent of the total.

Second, electricity is delivered to consumers under conditions of franchise monopoly. The cost of acquiring coal, including transportation costs, are passed directly through to consumers' electricity bills in regulatory proceedings either in fuel adjustment clauses or as expenses which are virtually unchallengeable.

Third, coal is the commodity over which railroads possess the greatest market power. In many cases utilities are served by only one railroad and there are no alternative means of transportation that are cost competitive (see Exhibit G-2).

This combination of economic factors and institutional arrangements makes electric utility ratepayers the captives of the railroads' captive shippers and one of the largest consumers or railroad transportation services.

Coal accounts for about 40 percent of the total volume of freight transported by rail. For the major coal hauling rail systems I have been discussing, coal accounts for over thirty five percent of freight revenues and close to fifty percent of operating profits, if not more.

Who pays the bill? Electric utility consumers do. Utility coal accounts for over 85% of all coal moved by rail (see Exhibit G-3). The utility rail bill is on the order of $4 billion—certainly more than half and perhaps two-thirds of the national rail bill. Thus, electricity consumers are not only the captives who need protection, they are also the primary source of railroad profitability.

Other shippers of bulk commodities suffer too. Shippers of bulk agricultural and industrial products, who sell into competitive markets, cannot pass unreasonable transportation costs through to consumers. Individual firms bear the burden in the force of diminished profits and the nation bears the burden in the form of reduced international competitiveness.

As we have seen, captive shippers and consumers do not receive credit for bearing this burden at the ICC. The faulty revenue adequacy test hides the huge burden placed on shippers and consumers beneath a veil of revenue inadequacy.

Consumers versus the ICC over revenue adequacy.—the consumer movement has long recognized the importance of the revenue adequacy test and the unfairness of the ICC version of that test. In July 1983 several consumer groups testified before the Subcommittee on Surface Transportation that the ICC' a revenue adequacy test was wrong.

The Consumer Federation of America pointed out that [13]

"The Commission responds with the argument that so long as the railroads are revenue inadequate their incentives continue to be to aim toward profitability. However, the coal-hauling railroads are, in general, already highly profitable according to most measures. Thus, the coal hauling railroads at issue in this proceeding are perfectly free to use unreasonable profits obtained from captive traffic to subsidize loses elsewhere occasioned by inefficiency or pure predatory pricing, of for example, truck competitive traffic."

On November 4, 1985, the Consumer Federation of America again testified before the Surface Transportation Subcommittee. Criticizing the complete unreality of the ICC's revenue adequacy test, it stated that [14]

"The ICC believes that the railroads are desperately short of revenue. It maintains that the major coal hauling railroads—the Norfolk Southern, the Burlington Northern, the CSX—would have to double their profits to be revenue adequate. We do not believe that and nobody else does."

A faulty revenue adequacy test wreaks havoc on the intention of the Staggers Act to protect captive shippers. In CFA's research papers submitted to the Surface Transportation Subcommittee in November 1985,[15] it was pointed out that—

"The revenue adequacy test is critical in the overall structure of the Staggers Act. The achievement of revenue adequacy by the railroads is an important goal of the Act, and, of more direct relevance, the Act provides that revenue inadequacy gives railroads the right to rate increases and other measures intended to enhance their viability. A faulty revenue adequacy test undermines the implementation of the entire Act and creates the potential for uneconomic and inequitable rates."

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[13] (Testimony of David Greenburg for the Consumer Federation of America, pp. 5-6).

[14] (Testimony of Dr. Mark N. Cooper for the Consumer Federation of America, p. 7).

[15] (The Financial Condition of the Major Coal Hauling Railroads in the 1970s and the 1980s, pp. 1-2). The Consumer Energy Council pointed out in Ex Parte 347: Coal Rate Guidelines—Nationwide, July 23, 1983, p. 80).

"Revenue adequacy is the key to the entire fabric of the Staggers Act. It was in pursuit of revenue adequacy that railroads were allowed to engage in the extraordinary measure of discriminatory pricing. That fact that coal rail rates currently are far above costs, which is contradictory to the rules of a competitive market, can only be justified by their need for revenue adequacy. A faulty revenue adequacy test takes a reasonable social goal of ensuring a financially health rail industry and turns it into an abusive exploitation of market power."

The ICC has repeatedly cited revenue inadequacy as justification for not exercising its regulatory powers. Revenue inadequacy is an impermeable shield behind which all manner of abuses can take place.

Most recently, the ICC has declared that it will not penalize railroads for management inefficiency as long as the inefficiency is not large enough to have been the sole cause of revenue inadequacy. To put this in general terms of regulatory procedure, if a railroad is not earning its authorized rate of return and engages in imprudent behavior, but the imprudence was not big enough to have caused the entire shortfall, then the Commission will force consumers to bear the burden of the imprudence.[16]

The write-up of the investment base to include costs that had been previously expensed has been justified on the basis of the inadequacy of revenues.[17] This is essentially retroactive ratemaking, which is prohibited under well settled principles of regulatory law.

Rates for captive traffic and for access to competing railroads may also be hidden behind the veil or revenue inadequacy.[18]

In each of these instances, a faulty revenue adequacy will unleash excesses. If the revenue adequacy test had been correct, the ICC might have been forced to find otherwise (presuming it did not create another facade behind which to hide abuses).

Beyond the formalities of the regulatory process, the faulty revenue adequacy test has distorted the evidence presented to the Congress by the ICC and the American Association of Railroads.

The financial indicator used most frequently by these two entities—return on investment—is wrong.

The calculation of return on equity is wrong.

The estimation of the revenue-to-variable cost ratio at revenue adequacy (as calculated in the Recyclables proceeding) is wrong.

A faulty revenue adequacy test leads to an understatement of the extent of differential pricing that exists in the industry, which means that captive commodities are bearing a larger part of the burden than the ICC and AAR have admitted.

THE LEGISLATIVE SOLUTION

The Staggers Act intended to protect captive shippers and ensure competitive access.—When Congress passed the Staggers Act it expected some shippers to bear a disproportionate share of the revenue required to achieve financial soundness for the nations' rail system. Consumers who ultimately bear that burden accepted the compromise. We did not accept the massive, fictitious revenue requirement that the ICC has concocted in the past half decade; nor do we believe that Congress expected 15 or 20 percent of all rail traffic to account for 100 percent of rail profits.

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[16] ICC, *Arkansas Power and Light Company, et al., Case No. 36719 et al.* Decided May 7, 1987, pp. 8-9.

Under the Guidelines, APL is entitled to rate reflief if it can be shown that its rates are higher than necessary as a result of inefficiencies in the pricing practices, investment or operations of the defendant carriers. The management efficiency constraint is a system-wide test. The dollar amount of those inefficiencies must be shown to be high enough so that, if eliminated, the carrier would be revenue adequate. There would be no economic justification for differential pricing of captive shipments above the level needed for the carrier to be revenue adequate but for the lack of efficient management. The management efficiency constraint is thus tied to the revenue adequacy constraint. There must also be a reasonable relationship between the extent of the remedy and the extent of the alleged inefficiency.

[17] Chairman Gradison, "Ex Parte No. 465; Railroad Revenue Adequacy—1985 Determination," Decided March 2, 1987.

As for the double count argument, I am not convinced by the arguments offered. Furthermore, whatever may be thought of the accounting technicalities, it is indisputable that there has been no double recovery of cost. For double recovery to occur the carriers must have actually recovered all of the costs they have incurred, and to have earned returns equal to their cost of capital for the period in which replacement costs were taken under the old system. They clearly have not done so and, for the period from 1979 to the present, railroad returns have fallen well short of their cost of capital, however defined.

[18] ICC, *"Ex Parte No. 445, Standards for Intramodel Rail Competition,"* Decided July 7, 1983, p. 11.

If reveneue adequacy is to be attained, or stockholders satisfied, carriers need to pursue the opportunities available under the statute.

The balance that Congress intended to strike between the real needs of railroads for revenues and the equally legitimate needs of captive shippers for protection from rate abuse and competitive access can be met if the ICC is forced to implement the Staggers Act as Congress intended.

The captive shipper provisions in the Act are intended to ensure that the creation of a financially viable and economically sound rail network is achieved in an equitable and efficient manner. The Act identifies revenue adequacy as a primary goal and allows differential pricing—price discrimination—in pursuit of that goal. However, neither the revenue adequacy principle nor differential pricing was intended to be a blank check. Congress expected that some price discrimination would exist in the railroad industry, but it also intended to keep such price discrimination to a minimum.

It allowed for a flexible jurisdictional threshold.

It stipulated that management had to be honest, economic and efficient.

It required the elimination of noncompensatory traffic.

It required the maximization of revenues from competitive traffic.

It stated that even in the quest for revenue adequacy the burden placed on captive commodities, such as coal, should not be onerous.

It recognized that the goal of energy security is a competing national priority.

The "pay-off" to consumers for bearing the burden of some differential pricing was the prevention of excess profits through the revenue restraint embodied in a revenue adequacy test. Vigorous implementation of realistic revenue adequacy tests and efficiency criteria, combined with the Long-Cannon facors which mandated the sharing of the burden of revenue adequacy, should have controlled the revenue requirement of the railroads and the burden placed on coal consumers and all captive shippers.

Procedural changes to create fairness in the implementation of the Staggers Act.—We propose that regulatory practices at the ICC be brought into line with those of other agencies at the federal and state levels. We propose nothing new or unique for the ICC. To the contrary, we only ask for an end to the new and unique theories and procedures that the ICC has concocted. We ask that it follow tried and true procedures and apply accounting principles applied by other agencies in dealing with similar situations

First, because it is so central to the functioning of the law, we believe that the revenue adequacy determination must be opened up to closer public scrutiny. The ICC must justify its determinations under closer scrutiny and with a public opportunity to at least comment. This is substantially less rigorous than state level regulation and regulation before certain other federal regulatory agencies, but it will be a help in establishing a reasonable target ROE and therefore a reasonable cost of capital.

Second, we believe it is crucial to apply the accounting procedures and concepts that are applied by virtually every other regulatory body in the nation. This must include scrutiny of the investment base and management practices of the railroads. We may not need the "used and useful standard" applied by the states, but we do need much more vigorous examination of these issues than the ICC's past total indifference. The Staggers Act stipulated such conditions, the ICC has yet to do anything to assess the performance of the railroads in these regards.

Third, we propose to shift the burden of proof from the shipper to the railroads on the issue of rate reasonableness in rate cases. In virtually every other ratemaking at the federal or state level the party requesting the rate increase bears the burden of proof.

We are placing greater stress on getting the pricing of competitive traffic correct by enforcing the Long-Cannon factors in the ratemaking proceeding. At the least, we ask that consumers and shippers not pay for inefficiencies in captive rates. This is, in fact, the way it is done in other industries where there are mixed monopoly and competitive services. Companies with mixed services have an incentive to maximize revenues from and shift costs to the monopolized services first, since it is less risky. The regulatory, in his function of protecting the capital consumer, should lean in the opposite direction—ensuring that the monopolist maximizes revenues from competitive services before collecting the residual from his captives.

Finally, the relationship between actual costs and prices must be considered. This does not mean that only cost can be considered in ratemaking or that costs must be the only basis for rates. Indeed, in industries where there are economies of scope (joint production) costs never are the only basis for ratesetting. The hypothetical cost relationship on which the ICC proposes to base rates—the fact that a rate is below the hypothetical cost of building a comparative transportation system—will never convince the shippers that they are being treated fairly.

Preserving the deregulatory principles of the Staggers Act.—At the same time that we are proposing to apply some of the general procedures of other regulatory agencies to the railroads, it is also clear that we are not altering the fundamental reforms of the Staggers Act. The railroads are, in fact, being treated much more leniently than other entities which possess the type of market power that they do.

The jurisdictional threshold remains at a revenue to variable cost ratio of 180 percent. That implies a level of differential pricing not subject to any regulatory oversight that may actually be more than some railroads need in order to achieve revenue adequacy, by a reasonable test.

The standard for scrutinizing the investment base is not the fully used and useful standard.

The rules for competitive access are much less stringent than we have advocated for electricity or recently won for telephones and even natural gas.

The rate suspension provisions of the Staggers Act, which allow railroads to collect rates while their reasonableness is being determined, are preserved. This is virtually unheard of in other regulatory agencies.

The encouragement of contracting in the Staggers Act remains in place.

What we have proposed is to level the playing field so that captive consumers and shippers have a reasonable chance of getting relief from the regulatory agency. Defenders of the Staggers Act frequently argue that a compromise was struck and it should not be reopened. The truth is that the compromise existed in the law, but not in its implementation by the ICC. We believe that Congress, and only Congress, can restore the balance by shifting the burden of proof and stipulating a few fundamentals for establishing revenue adequacy and maximum rates.

Fairness in regulatory proceedings.—In the past four years, I have appeared on behalf of consumer and low income organizations in about three dozen proceedings at the federal and state levels. We win some cases and we lose some. We win parts of some cases and lose other parts. But above all, we have a sense that the process is reasonable—that the rules are reasonably impartial and the deliberative bodies are reasonably objective and unbiased. There are things we would like to change and improve, but the process is fair enough that we can live with it.

That simply is not the case with the ICC's revenue adequacy and maximum rate proceedings. The scales have been so tilted in favor of the railroads and the burden placed on complainants so onerous, that we despair of getting a fair hearing or achieving a sensible result. Our feeling of despair is echoed in the sentiments of a series of judicial decisions indicating that we have little hope of prevailing under the current rules, procedures and attitudes at the ICC. All we are asking the Committee to do is to ensure an equitable set of rules applied by a reasonably impartial body and we will take our chances on the process.

I appreciate the opportunity to appear before the Committee and look forward to working with the members in developing effective solutions to these pressing consumer problems.

CFA
Consumer Federation of America

July 20, 1987

Ernest F. Hollings
Chairman, Committee on Commerce, Science
and Transportation
United States Senate
Washington, D.C. 20510

Dear Chairman Hollings,

Enclosed you will find responses to the question you presented to me as a follow-up to the Surface Transportation Subcommittee's hearings of June 9, 17, and 24.

In addition, I have enclosed a letter that I have sent to Senator Exon dealing with a question about agricultural freight rates, which he posed to me during cross examination. Since this is an important issue and the hearing record appears to be closing, I would like this included.

Sincerely,
Mark N. Cooper
Dr. Mark N. Cooper
Director of Research

INVESTMENT

1. Mr. Voytko has testified that diversified investments are a positive development and that the more a railroad's investments are concentrated in railroad operations, the less attractive a railroad is on Wall Street. How do you respond to this?

Mr. Voytko repeatedly confuses the holding companies -- which are traded on Wall Street and, therefore, the object of his professional attention -- with the railroads -- which are the object of concern in the Staggers Act. The goal of the Staggers Act is to have a financially sound railroad system.

The Staggers Act does not contemplate, nor could it expect, other lines of business in a holding company to subsidize rail operations that were not making it on their own. At the same time, it should not tolerate rail rates on captive movements that are unfairly generating excess resources to be spun-off into other lines of business.

Within that context, the owners of railroads who take a fair return of and on their capital and perceive one line of business contracting, but wish to keep their capital together in a holding company, can certainly add other lines of business. Alternatively, they can raise new capital in money markets to form or expand the holding company.

Thus, if rail holding companies wish to diversify, the consuming public should not care one way or the other. However, because many railroads have at their center a core of monopoly business, which Congress continued to subject to regulation and which can be used to unfairly exploit captives, the consuming public has a right to ask whether the the resources used to diversify have been fairly earned. If the railroads create "strong" holding companies with ill-gotten gains, the consuming public may not be better off.

It also must be recognized that the record of diversification of American industries is very mixed. Diversification itself is no panacea and we have seen many such efforts end up losing money, rather than making it.

Indeed, Mr. Voytko's analysis of the stock performance not only suffers from his failure to distinguish between holding companies and railroads, it also demonstrates the vagaries of diversification. Three of the nation's largest railroads acquired oil and gas resources in the early 1980s, when oil was trading at over $30 per barrel. Subsequently, when oil prices collapsed, oil industry stocks took a beating. This was at exactly the moment that the strong stock market was taking off.

In short, the real issue is not whether or not you diversify, but what you buy and whether you can effectively manage a different line of business. Rail managers may not prove to be good hotel managers, just as oil company management (for example) proved to be poor department store managers.

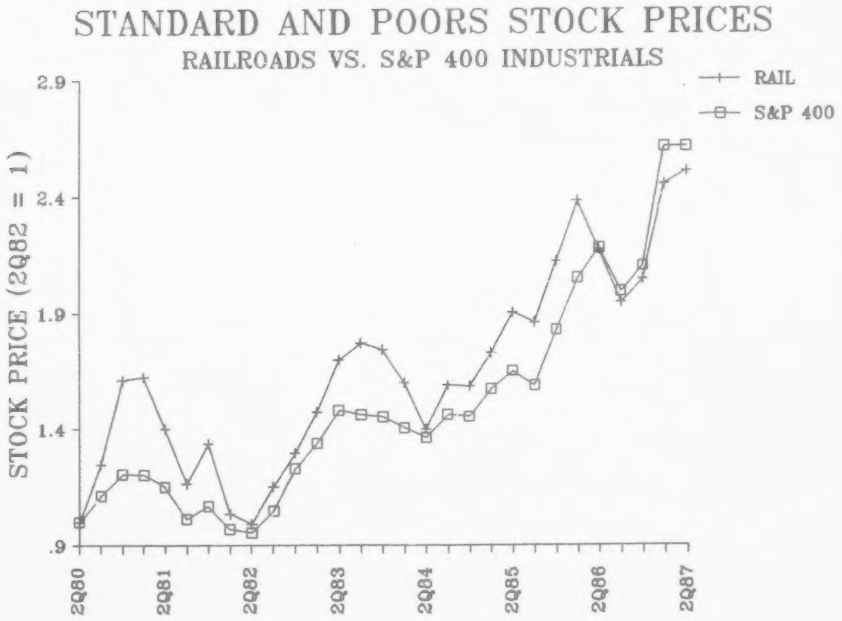
2. As you know there have been significant gains in the stock market in recent years. Mr. Voytko has stated that in spite of these gains, railroad stocks have not kept pace with the market since 1980. Please comment on this.

Mister Voytko's conclusion is misleading. It is entirely based on the choice of an incorrect base period. Railroad stocks have performed about the same as the stock market since the passage of the Staggers Act.

Mr. Voytko calculated his changes in stock market prices using the fourth quarter of 1980 as the base period. However, the Staggers Act passed both houses of Congress in the third quarter of 1980. In fact, the fundamentals of the Act were clear by late summer. The stock tends to take this type of information into account very quickly.

The following figure shows the stock market performance of rail stocks compared to the Standard and Poors 400 Industrials using the second quarter 1980 as the base period. One could use any quarter back through 1979 (when regulatory reform in the rail industry was being debated) and come up with essentially the same results. It is quite clear from this exhibit that the stocks have performed in a fashion similar to the rest of the market.

The figure also makes it clear that railroad stocks have participated in the strong market that has prevailed since the second quarter of 1982.



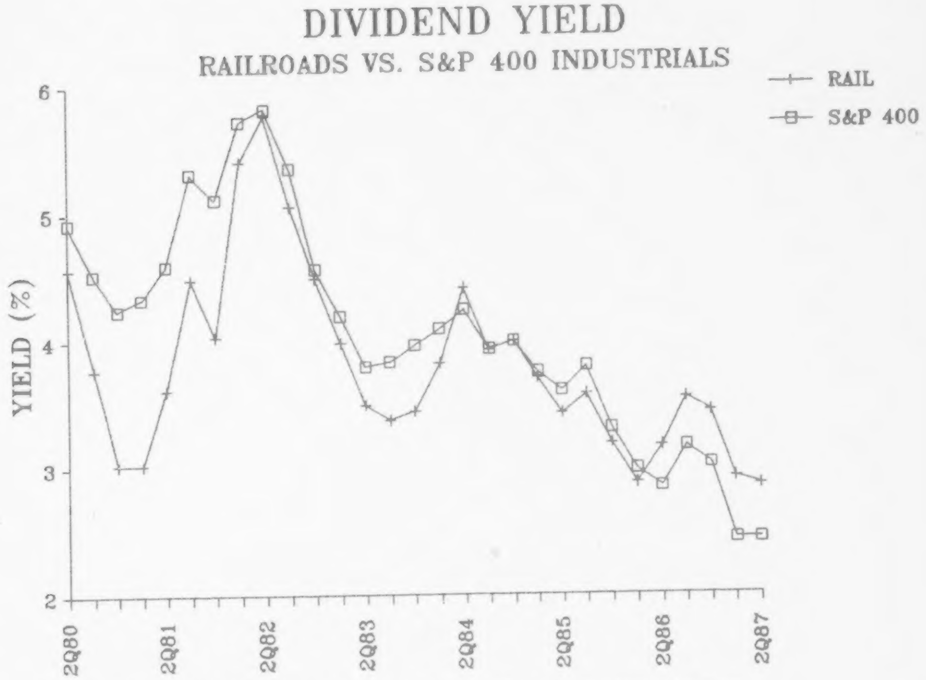
STANDARD AND POORS STOCK PRICES

RAILROADS VS. S&P 400 INDUSTRIALS

SOURCE: Standard and Poors, Analyst's Handbook, various issues.

It should also be observed that investors get their value out of stocks in two ways. One is appreciation of the stock price in the market. The second is dividends. In the period since the passage of the Staggers Act, dividend yields on railroad stocks have improved relative to the yields on the Standard and Poors 400 Industrials.

As the following figure shows, just prior to and immediately after the passage of the Act, yields on railroad stocks were lower than on the S&P 400. Yields on railroad stocks have come to equal and in the most recent period exceed the S&P 400.



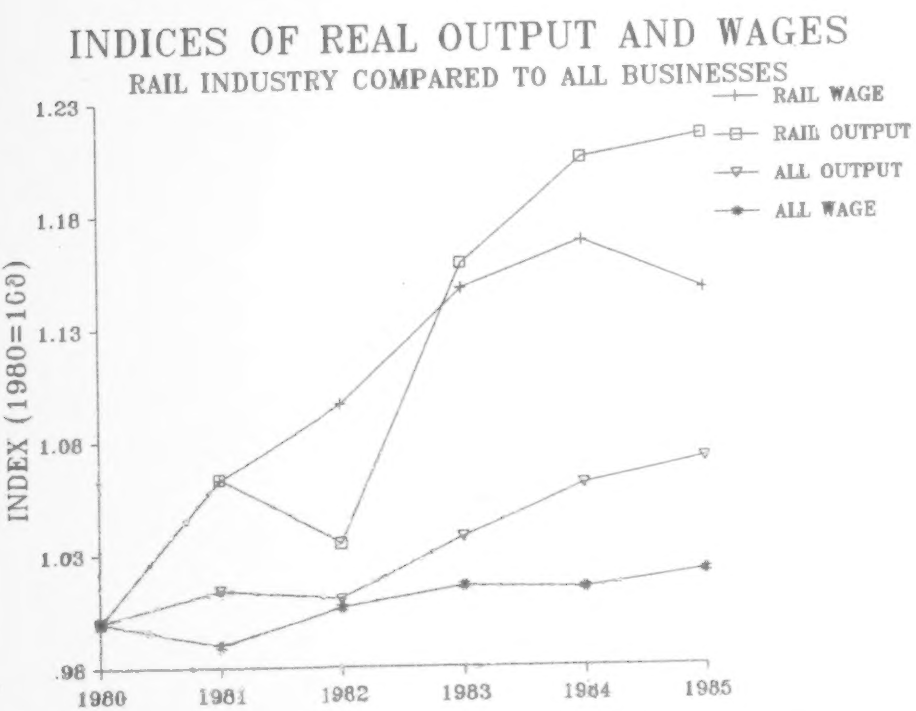
SOURCE: Standard and Poors, Analyst's Handbook, various issues.

LABOR AND OTHER COSTS.

3. Do you have any opinion as to the extent to which labor, FELA, retirement, taxes and other costs might impact the rail industry as compared to truck and barge competitors and to other american industries?

We have taken no position on the labor related proposals which have been proposed by either rail labor or the railroads. We do examine the costs of operations of the railroads as part of our financial analysis.

As the following figure shows, with respect to labor costs, both productivity and wage rates (including fringe benefits) have been increasing faster than for all businesses so the relative position has not changed much.



SOURCES:
Railroads: Association of American Railroads, Railroad Ten-Year Trends, 1986, Tables II-A-1, II-A-4, and III-B-9.
All Business: Economic Report of the President, Appendix B, January 1987, Table B-43 for output and wages; Table B-3 for the GNP deflator.

CURE BILL

4. Please elaborate on the impact you fell passage of the Consumer Rail Equity Act may have on the financial well-being of the rail industry.

The goal of the Consumer Rail Equity Act is to achieve procedural and substantive fairness in the treatment of captive shippers. If it has an impact, it will occur in the course of righting wrongs that have been committed by the ICC. However, for a number of reasons, I believe that the impact of the Consumer Rail Equity Act on the financial well-being of the rail industry will be small.

First, the bulk of the changes are procedural, shifting the burden of proof, requiring the Commission to make findings, etc.

Second, fixing the revenue adequacy test will simply establish a more realistic estimate of revenue need. Those railroads which are found to be revenue adequate under a reasonable test might be affected, since they would lose some pricing flexibility. Having been found revenue adequate, however, this should be no great cause of concern.

Third, by focusing on the Long/Cannon factors, the proposals aim to achieve the efficiencies identified by those factors -- e.g. elimination of noncompensatory traffic and maximization of revenues from competitive traffic. This should not adversely affect revenues.

Fourth, there is a small number of rates and rate cases that would be affected by the Consumer Rail Equity Act changes. Rates generally would not be lowered, but future rate increases on captive traffic and traffic denied competitive access would be harder to secure. However, if such increases can be shown to be reasonable, they will be granted.

We believe that captive traffic and traffic denied competition has not been treated fairly as the Staggers Act intended. The inclusion of the Long/Cannon factors made it clear that the financial well-being of the railroads was not to be achieved at all costs to captive shippers. The needs of the railroads were to be balanced by a consideration of the burden being placed on specific classes of shippers. The Long/Cannon factors have not been implemented by the ICC and if the impact of the Consumer Rail Equity Act is to better discipline rates for captive traffic, we think that is what the Staggers Act intended.

The railroads could respond to this discipline on their use of market power by searching for other sources of revenue or controlling costs. In the end, there will be some small impacts on some railroads.

CFA

Consumer Federation of America

July 20, 1987

Senator J. James Exon
Chairman, Subcommittee on Surface Transportation
United States Senate

Dear Senator Exon,

Although the Consumer Federation of America has focused its attention on coal rates, we have always been concerned about the impact of the ICC's mismanagement of the Staggers Act on the farm community. We have worked closely with a number of farm groups -- such as the National Farmers Union and the National Council of Farmer Cooperatives -- who support the Consumer Rail Equity Act.

When I testified before the Subcommittee, you asked how I would interpret the changes in rail rates for grain presented by the American Association of Railroads (AAR). Stimulated by your questions, we have recently begun to conduct more detailed analysis of rail rates for agricultural commodities. Since the hearing record will apparently close soon, I would like to share our preliminary findings with you and submit them for the record.

As I suspected, the AAR uses the wrong deflator (the Rail Cost Adjustment Factor unadjusted for productivity). I have also discovered that the AAR sample of rates may also overstate the rate decline because it may be improperly comparing single car to unit train rates. In short, the AAR may be comparing apples to oranges and it is definitely dividing by watermelons.

A straightforward way to understand transportation rates from the farmer's point of view is to compare them to other costs of doing business and the prices received for output. To keep the comparison straightforward, I am relying only on government data (so no question about data sources arises) and I present all figures in current dollars (to avoid questions about the selection of a deflator). What I find is that farmers have not gotten such a great "deal" from the railroads.

The June issue of Agricultural Outlook, published by the Department of Agriculture, shows that rail freight rates for farm products, grain and food products were 30 percent higher in 1986 than in 1979-1981, the period just prior to and at the beginning of the implementation of the Staggers Act (see Figure 1). Over the same period the priced received by farmers for their crops declined by 12 percent.

Also over the same period, the price of diesel fuel fell by 44 percent (see Figure 2). Interest rates have plummeted as well, with

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the prime rate being cut in half. The return on equity of manufacturing corporations, which goes a long way toward determining the cost of capital in the nation's equity markets, has fallen by over 30 percent.

The above costs are general throughout the economy and affect all sectors, including agriculture and the railroads. A few specific costs of business for the two industries are also interesting to consider.

Through the end of 1985, the total wage bill in the rail industry was down about 5 percent, but up by over 20 percent in agriculture. The railroads have reduced the number of freight cars and locomotives by 22 and the aggregate horsepower of locomotives by 13 percent. Agriculture has reduced its use of machinery by about 17 percent. The above figures are from the Association of American Railroads, Railroad Ten Year-Trends, and the Economic Report of the President.

It is easy to see why farmers are not overjoyed by the "deal" they have gotten from the railroads. They have watched the railroads' cost of doing business fall much more rapidly than rail rates for agricultural goods.

This points to a second major concern among farmers, which I briefly mentioned at the hearings. Rail rate have been kept up in the face of an extremely soft market for farm products.

Studies by agricultural economists show clearly that market power is being exercised by the railroads (see Figure 3). The farther a farmer is located from water transport or a competing railroad, the higher the rate he is paying. For corn, all other things equal, a farmer with one railroad pays about 30 percent more than a farmer with three railroads. For wheat, all other things equal, a farmer 300 miles away from water transportation pays about 30 percent more than a farmer who is 100 miles away.

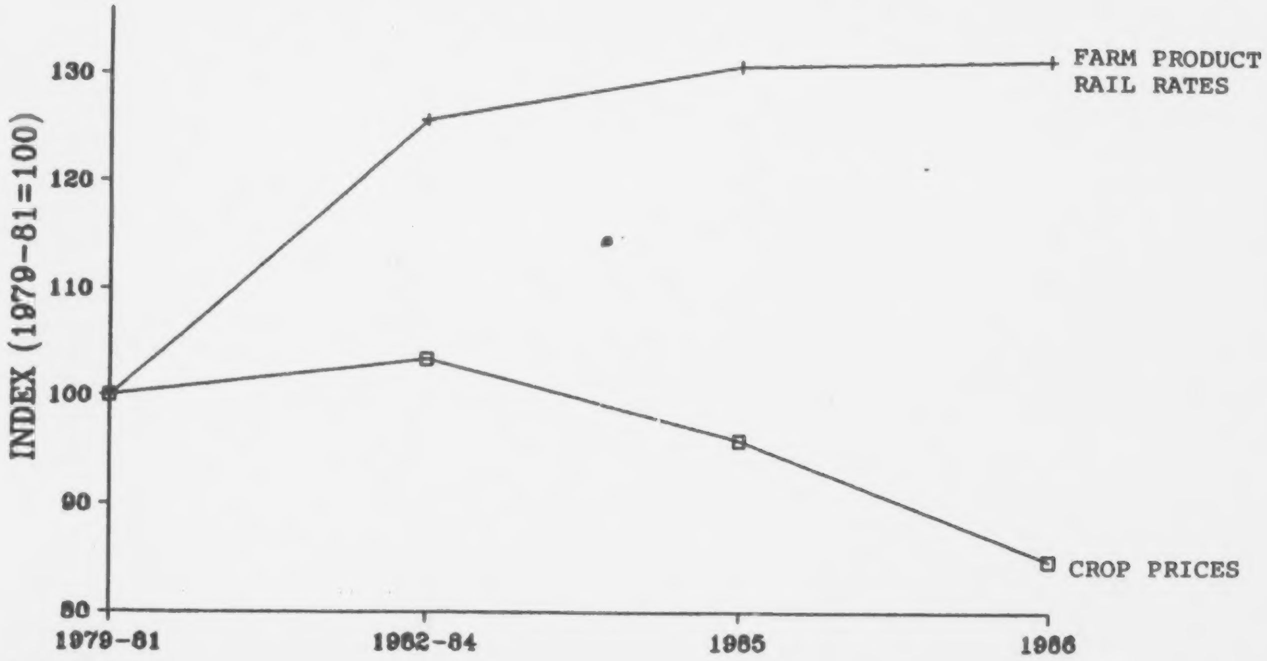
If the railroads can exercise this market power in a relatively soft market for commodities and with a surplus of cars, farmers fear that they will exercise much more market power in tight markets. The farmer faces the prospect, if crop prices rise, of watching the railroads capture the benefits through freight rate increases.

Under the current regulatory regime, there is little that the ICC has done or can do in a timely to prevent this type of exploitation. That is why we believe it is extremely important for Congress to act now to eliminate current abuses and set up mechanisms which will prevent future abuses.

Sincerely,

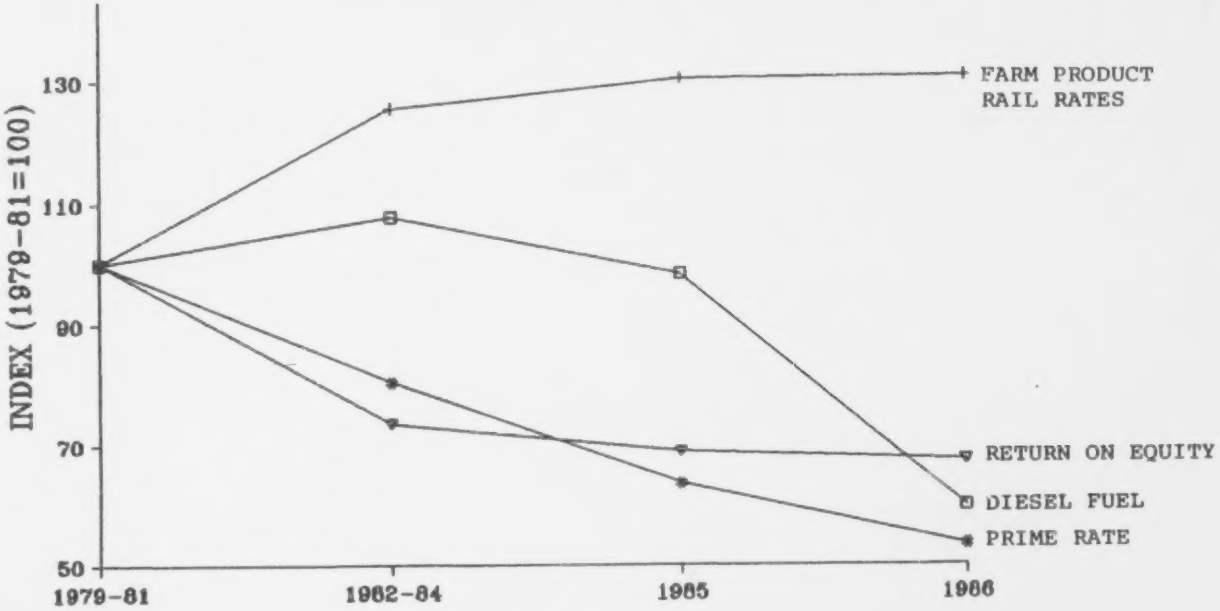
Dr. Mark N. Cooper
Director of Research

FIGURE 1:
FARM PRODUCT RAIL RATES COMPARED TO CROP PRICES



SOURCES:
Rail Rates: *Agricultural Outlook*, June 1987 (U.S. Department of Agriculture), p. 22, based on Bureau of Labor Statistics Farm Product Rail Rates.
Crop Prices: *Economic Report of the President, Appendix B*, January 1987, Table B-96.

FIGURE 2:
FARM PRODUCT RAIL RATES COMPARED TO OTHER COSTS

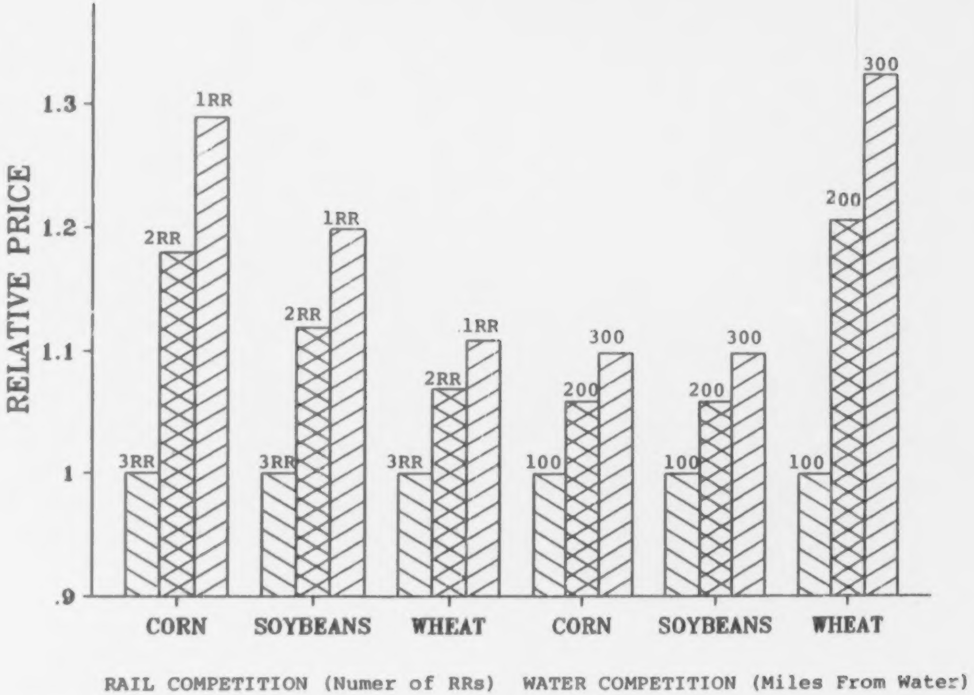


SOURCES:

Rail Rates: _Agricultural Outlook_, June 1987 (U.S. Department of Labor), p. 22.
Return on Equity and Prime Rate: _Economic Report of the President, Appendix B_, Tables B-68 and B-88.
Diesel Fuel: _Monthly Energy Review_, March 1987 (U.S. Department of Energy), Table 9.7.

FIGURE 3:

RATE LEVELS AND COMPETITION



SOURCE:
James M. MacDonald, "Competition and Rail Rates for the Shipment of Corn, Soybeans, and Wheat," Rand Journal of Economics, 18:1, 1987, p. 158.

Senator **Rockefeller**. Thank you, Dr. Cooper.

Mr. Voytko, what do railroads, not the holding companies but the railroads themselves, need to do themselves to become more profitable in your judgment? Do they need to charge their captive traffic more or their competitive traffic more, or what?

Mr. **Voytko**. Well, in most competitive industries, and this is a pretty thoroughly competitive one, you do not decide what you are going to charge. You work in a marketplace and those prices evolve out of the continual interaction between yourself and your customers.

I wish it were that easy in my own industry, to simply say that if we have an earnings shortfall we will simply raise our prices. But I do not think that that is an option that is open to the railroads, not given the trucking competition.

I also happen to follow the trucking industry for PaineWebber and, as you know, they are intensely competitive. It is just not an avenue of relief that I see.

Senator **Rockefeller**. So they will not be able to raise those competitive prices?

Mr. **Voytko**. I would be very surprised if they could, I would agree with the comments made by the AAR earlier on this point. The rails might very well try, but I doubt very much the shippers would stand for it.

Senator **Rockefeller**. Are the railroads in your judgment generating enough money to make capital improvements, and are those improvements coming from retained earnings or borrowings?

Mr. **Voytko**. Well, in general the railroads are becoming more leveraged. But remember that they are holding companies, so it is difficult to say that this green dollar came from here and went to there, because all green dollars look alike.

But I will say this. Across the industry, there appear to be strong indications that the companies want to put less money back into the railroad business. They are selling off track assets. They are proud of their programs for reduced capital spending, and when they come to Wall Street they tell analysts how much they have reduced capital spending and how they hope to keep it low. That includes Conrail by the way.

So I presume that they are going to try as much as possible to keep capital spending down and reinvestment in the rail business at a minimum.

Senator **Rockefeller**. Dr. Cooper, do you want to comment on that?

Dr. **Cooper**. Well, in point of fact they have been generating and paying for their "five-year growth needs" out of internal funding more than other businesses. That the industry is shrinking is no surprise to anyone. It was expected. It was overbuilt.

The consist of the economy had changed, so people expected the industry to shrink. The industry as a whole, and particularly the railroads we have looked at, have in fact been reducing their leverage. That is, they have been reducing their debt with internally generated cash flow, depreciation, earnings, et cetera.

So that if you look at their performance over the past five years from their financial ratios, they have been strengthening their position, not weakening it. And no one, I think, maintains that they have not been making the necessary investments to provide rail service.

You have heard them testify over and over and over again that the capital base is stronger, and it has been done primarily with internal funds. They have not been borrowing to make those investments.

Senator ROCKEFELLER. Mr. Voytko, would you agree that the railroads are making progress in reducing their debt?

Mr. VOYTKO. Well, as far as holding companies I think the answer is no. They are raising debt levels. Union Pacific's leverage has increased. Norfolk Southern's has not, but it is not for lack of effort. They have tried to make acquisitions outside the railroad business, as well as inside, but most recently inside.

Burlington Northern's leverage has increased, and CSX's leverage has increased with its purchase of Sea Land. So the answer is I think debt levels are up.

Regarding Mr. Cooper's response it depends on what day you start measuring. If you start at the begining of the cash buildup stemming from the one-time writedown of the frozen asset base, which has now ended, they did de-leverage for a period of time. Also they were not buying equipment and they were paring their track size. I believe track is down about ten percent since the passage of Staggers.

So I observe some railroad holding companies increasing debt, but I would have to go back and look at the aggregate to sum up the changes.

Senator ROCKEFELLER. Dr. Cooper.

Dr. COOPER. Well, the difference between holding companies and the rail operations becomes fairly important. If you bought oil and gas at $30 a barrel, which at least two of the companies that were mentioned bought, you probably are scrambling around now since oil went down to $10 and has come back up to $20.

So if you look at the stock market performance, it is heavily influenced by companies which bought oil and gas when some of us believed it was way overpriced. If you look at the statistics for railroads compiled by the AAR and used by the ICC, you will find that the rail operations, those lines of business have in fact been reducing their level of indebtedness.

And again, we have slipped between the two levels and you can see different things at the two levels between the rail operations and the holding companies.

Senator ROCKEFELLER. Mr. Voytko, are the railroads able to raise equity capital or borrow money from the capital markets these days?

Mr. VOYTKO. They can do both. You can almost always have access to the capital markets at a price.

Senator ROCKEFELLER. Do you believe that the railroads are running a basically efficiently, safe and sound system?

Mr. VOYTKO. Well, I have looked at the testimony given on accident data and claims data, and both appear to be improving since the passage of Staggers. The fact that the railroads have made purchases outside the industry, as my colleague here has said that he perceives as being uneconomic, really does not have much relationship to whether railroading is appropriately regulated or not.

Senator ROCKEFELLER. I am under a five minute time limit, but there is nobody else here, so I guess I am not.

That was the happiest look around I have ever taken.

Mr. Voytko, as an investment analyst to what use do you put the ICC's finding on revenue adequacy or revenue inadequacy, if you would, please?

Mr. VOYTKO. Well, I think analysts on Wall Street will differ tremendously as to what they think is important in influencing the stock price of a holding company which happens to own one or more railroads. I happen to keep a close eye on the revenue adquacy debate because a trend toward more stringent economic regulation could be material to the stocks.

For example, I also happen to believe that railroad retirement is an important issue and the trend toward resolving it or not will have some bearing on the future performance of railroad stocks. I do not think that there is any single rate case, however, that is large enough to make a significant difference in the stocks.

But, if there were a change enacted into law such as that envisioned in the CURE proposal, I think that would be significant and it probably would affect the railroad stocks.

Senator ROCKEFELLER. Well, let us not look at any prospect of legislation or not. If it is therefore a relevant indicator to you, how do you explain as an investment analyst the fact that railroad annual reports, 10k's, and other required documents filed with the SEC do not mention a railroad's status as revenue adequate or revenue inadequate?

Mr. VOYTKO. First of all, analysts in general always want more information. It is something companies often tell us; we are never satisfied. So if you ask, would I like to see it, sure. Would I like to see any additional information? You bet. Analysts are never satisfied.

It might be that they have never been asked to put the revenue adequacy funding in because it is so widely known. I do not know of any of my colleagues on the Street that are not aware of it. There may be some, but at least the ones I interact with regularly know.

I would suggest the whole issue relates, too, to this whole matter of regulatory uncertainty. The government just recently sold Conrail stock to the public and yet only a few months later is considering changes in the basic regulatory structure of the industry that might very well affect the price of that stock. You might imagine investors in Conrail might take a look at that and say that this flip-flop was of equivalent gravity or concern to them as the issue of not having ICC rates of return on SEC filings.

The last thing, too, to remember is that the rail ROI's are included in the holding company numbers—it all works out in the wash. True, the holding company results do not provide the level of detail that are possible if there were ICC rate of return figures in the SEC filings. But remember there are the SEC numbers on the holding company itself, and so we do get the effect, albeit put into the aggregate numbers, of the performance of the individual railroads.

Senator ROCKEFELLER. But is it not just somewhat coincidental or amazing that you have all of these annual reports and what you indicate about ICC's revenue inadequacy judgments may very well be known on Wall Street and elsewhere, but so, I would assume, would a lot of information in these reports?

Is it not just somewhat extraordinary that nowhere is revenue inadequacy as determined by the ICC mentioned? I mean, are not those reports required? It is not just the question of what is known and what is not known. But is there not a real question of legality here?

I do not mean to be pressing that menacingly, of course.

Mr. VOYTKO. That is perfectly fine, Senator. The answer is yes, SEC filings are required. Again, I do not have really too much more to add to my previous answer. I would like to see them, to show how the rails perform under the ICC standards and a statement of revenue inadequacy.

But I am not amazed that they are not there, again for the reasons that I stated earlier.

Senator ROCKEFELLER. Okay. Dr. Cooper, as I understand it—and I was not here at the time, obviously, but the Long-Cannon factors were so important to the passage of the Staggers Rail Act in 1980 that in fact one could argue that if they had not been included there would have been no Staggers Rail Act at all.

Would you say that they are being usefully or properly implemented, that is the Long-Cannon factors?

Dr. COOPER. The Long-Cannon factors bear the names of two important Senators who came to a compromise, and so I agree that it is extremely important, it was extremely important in passing the act.

They essentially established the terms of the captivity of those of us who pay the ultimate bill, and we have seen then a complete failure to implement them. And I will just give one example.

In one of the three famous victories that captive shippers have won in the years since we have been actively pursuing legislation, the *Arkansas Power & Light* case, the Commission said that management inefficiency, which is a crucial consideration in the Staggers Act, that is not large enough to create revenue adequacy in and of itself would not be allowed for relief to the shipper.

That is, if the inefficiency is small you are not going to get any relief from it. So that is one of the reasons why we care about the revenue adequacy, because if you lower the target and you have an inefficiency that would make you adequate, under the current rules you could get some relief for it.

So getting rid of traffic that is noncompensatory, which is a major inefficiency, maximizing contributions from competitive traffic—and of course, Mr. Dempsey has testified we always get as much as we possibly can. That is what everyone in every regulated industry says about its more competitive lines: We get as much as we possibly can.

The role of the Commission is to say: Prove it to me, convince me that you did. The ICC never even looks.

Maximizing contribution and spreading the burden. The Long-Cannon factors said that one class of customers should not be unfairly burdened. And yet we now have a decision, a series of decisions, in which the coal rate guidelines not only use stand-alone costs, which tends to give you a high price, not only fails to give you relief from management inefficiency, but then it turns around and identifies different classes of captive customers who have a different test which looks like it will be a much easier test.

So we have been singled out under the ICC's inconsistent application of the maximum rate guidelines. We have been singled out, the consumers of big coal, electric utilities, the customers who pay the bill, to pay a very high rate.

And as we read the Staggers Act, that is not an effort to balance the burden. But that was one of the Long-Cannon factors. So they have violated, in our opinion, each and every one of the Long-Cannon factors.

Senator ROCKEFELLER. Which brings one to the *McCarty Farms* case. You are a lawyer, I take it.

Dr. COOPER. No, I am not.

Senator ROCKEFELLER. You are not a lawyer.

To me that is a very interesting case, because I think it signals the direction in which we may be going. Is it your expectation that the railroads will appeal this case?

Dr. COOPER. I certainly expect the railroads to appeal the case. It has a presumptive cap in it, something which we have never advocated, and the railroads have repeatedly found presumptive caps to be not to their liking. So I expect the railroads will challenge it.

Senator ROCKEFELLER. If they were to do that—and I understand this is all hypothetical—how long would that challenge probably take, based upon the very few other cases?

Dr. COOPER. I suspect that it would take several years, at least, to work its way through the court. It might get remanded. We were almost ten years in the making of the coal rate guidelines. That might be a little long since, certainly on the House side, speed is of the essence, and I expect on the Senate side as well. The Commissioners cannot come up here and drag their feet.

But clearly, you are looking at a number of years before it gets resolved.

Senator ROCKEFELLER. During the time of that appeal, is it not likely that any similar grain cases that might be pending would be held in a pending status until that appeal was finally resolved one way or another?

Dr. COOPER. I think that is what happened in most of the coal cases, and one can expect that they would probably have to just wait until they resolve that issue.

Senator ROCKEFELLER. Dr. Cooper, the railroads have charged that the CURE effort is probably going to increase utility profits. Is that a correct charge?

Dr. COOPER. No. I mean, electricity is delivered to consumers as a franchised monopoly. Expenses are passed through to consumers. Coal is a fuel expense. In many states it is an automatic fuel adjustment, and transportation costs are part of the cost of coal.

In other states it is a normal expense which is subject to challenge, but virtually impossible to overturn. So basically, it is a direct expense, and that is why we care so much, because we pay every penny of that. And any reductions, as we see it, in transportation costs will be passed through to us on a penny for penny, dollar for dollar basis.

Senator ROCKEFELLER. And there is no way out of that? That is just simply the way the law reads, is it not?

Dr. COOPER. That is one of the most vigorous areas of utility regulation at the state level. Expenses are scrutinized extremely carefully, and there is no way that utilities could profit from a reduction in their transportation costs.

For instance, if they were buying coal from themselves and trying to set the price, their own mine mouth price in those cases where they owned it, up, that would be challenged vigorously at the state public service commission level. So even in the instances where they happen to own some coal, they would not be able to capture the rents that were created by a reduction in transportation cost.

Senator ROCKEFELLER. Dr. Cooper, what would the Consumer Federation of America think—and you have alluded to this—about a rate reasonableness test at the ICC that caps rates for small coal and all other captive commodities, but judges large coal by the stand-alone cost test?

Dr. COOPER. Why me? I mean, why us? I mean, why pick one commodity and say, we are going to put you through what the Commission itself has alluded to as a bizarre, difficult test, which I think is always going to yield higher results? Why single us out?

We believe that that clearly violates the Long-Cannon factors, which said to look at how the burden is spread. So they have singled us out, distinct from all commodities, to bear what we think is an unfair burden.

Senator ROCKEFELLER. You know, this makes me think very much of the coal fields of West Virginia, with numerous spurs and numerous lines going up into those mountain hollows and shipments to a number of different destinations.

The only—and I guess I happen to know that the only captive shipper victories using stand-alone costs, that being the Omaha Public Power District and the Arkansas Power & Light Company cases, both involve coal from the Powder River Basin, which involve huge volumes of coal moving on just one rail corridor jointly owned by the BN and the Chicago and North Western.

You know, one would just have to worry about whether this is the direction that we are headed in.

I would take it that you would agree that the ICC is not being very consistent, and that they perhaps, even after seven years after the enactment of the Staggers Act, really have no fundamentally consistent approach to rate reasonableness?

Dr. COOPER. Well, the fact that stand-alone cost works coming out of the Powder River Basin is a result, as it has been described to me, essentially the BN is a large conveyor belt coming out of the Powder River Basin. It is a coal conveyor belt, just a constant flow of unit trains moving tremendous volumes.

In most other places, it is going to result in much, much higher rates, and those are exactly the kind of places where McCarty Farms says: Here, we will use a different test for you folks because we recognize the difficulty of the economic reality.

To me that is completely arbitrary and unfair and violating of one of the key provisions of the Long-Cannon factors.

Senator ROCKEFELLER. Do you have any comment on that, Mr. Voytko?

Mr. VOYTKO. Only a general comment, which is this. The proponents of CURE all state at the beginning that they believe in differential pricing, and then there is a big "but. They always turn to this issue of either management efficiency or less compensatory traffic and what can be done about that in order to relieve their perceived burden.

In other words, they seem to be implying that there are two things that could be done. First the rails push rates up—and Mr. Cooper alluded to it earlier—for other shippers. Should we have the ICC look at these rates for other shippers to see if they are high enough?

And yet, given the amount of traffic that the rails have lost to the trucking industry, common sense would tell you that it is a very competitive market or they would have raised their rates long ago. They are under tremendous pressure to get their profits up.

So the cure group suggest the rails either push rates up for other shippers that are viewed as noncompensatory—even though I would argue that the traffic would go elsewhere and has demonstrated that it will go elsewhere—or make the rails most efficient. And yet, nowhere have I seen from any consumer standpoint, from any shipper standpoint, testimony that bears on the biggest opportunity that the rails could possibly have to be more efficient, and that is rail labor, rail labor, rail labor. Productivity, wage levels, FELA, you can go on down the list.

You asked me earlier if I was amazed by the omittance of ICC revenue adequacy findings from SEC filings. What really amazes me is that shippers are not here at this table pounding it, saying something has to be done about the rail labor, productivity, and pay scale question, because we are footing that bill, and if something is not done about it, we do not have any opportunity or any hope for better rail service or lower rates.

Senator ROCKEFELLER. Just one final question, Mr. Chairman. Mr. Voytko, would you agree or disagree that it really boils down to the fact now that captive shippers are paying the entire profitability picture?

Mr. VOYTKO. Oh, no, not at all. I would not argue that.

Senator ROCKEFELLER. You would not argue it? You would agree with it?

Mr. VOYTKO. I would not say that I have seen evidence that suggests they are producing all the profit in the industry. In fact, I think you just heard testimony from Mr. Dempsey that said that if you took away all of the traffic below 180 percent of variable cost, you would have worse profit results for the industry.

It is interesting that if you decide that you want to try to force "noncompensatory traffic" off the system, if you follow that train of thought to tis logical conclusion, you get a stand-alone railroad system. That is what you end up with if you force the railroads to abandon lines to give up the traffic because they cannot raise the rates in the marketplace and to shrink back to only with the high density lines that are populated by shippers that most need the railroads, like the utility industry.

Then, in fact, you will get an industry that looks very much like a stand-alone railroad, and with all of the costs no longer being spread among these other shippers, who do make some contribution to fixed costs. Then all of the fixed cost burden will be on the CURE shippers. And the rates required under such a system will come as a big surprise to them.

Senator **Rockefeller**. Dr. Cooper?

Dr. **Cooper**. Well, the question of the contribution to fixed costs always intrigues me, because the question I always ask, and we have asked it about the telephone industry frequently, is if you shed the load, do you shed some of the costs as well?

And it is a matter of, I believe, clearly established fact that the heavy bulk commodities are fairly low cost in terms of certain kinds of engineering and construction demands. And so—as for instance, data use in the telephone system places heavy demands on the system. Well, maybe piggyback also places heavy demands on the system.

What kind of capital investments have been made to get a 12 percent markup over variable costs when *McCarty Farms* was up at 300 percent, and coal traffic is moving at at least, you know, twice, 220 or 225 percent?

So that whenever someone says, well, but we are making a contribution to the fixed costs, I always ask: Well, what kind of contribution are you making to the costs of the fixed costs? How many costs do you bring with us?

And it may well be that you will end up with a highly specialized transportation mode that specializes in bulk heavy commodities. Now, there may be a shakeout and the system may shrink. But when you have such a thin margin, 12 percent of variable costs, I am always interested to see the capital costs that have gone to get me that 12 percent, and I would like to see the analysis, because it is my understanding that piggyback can be pretty expensive because of where it goes and the kinds of demands it places on the system.

Mr. **Voytko**. But Senator, now we get to the heart of it. It strikes me, given the comments just made by Dr. Cooper that this is really an issue between the CURE shippers and all of the other shippers. If the CURE shippers see reregulation as a movement toward a highly specialized railroad system, more economically regulated, designed to serve their kinds of commodities, then what happens to the other shippers?

Are they supposed to just go elsewhere or go to the trucks? I would suspect that there are a lot of shippers in this country that would be very upset at that notion.

Dr. **Cooper**. Let me respond in two ways. One, if they have competition they can get to the trucks. We do not have the competition, so we cannot get to an alternative mode.

And two, we constantly hear about the CURE shippers. There is a Coalition for Rail Fairness and Competition, made up of the coal shippers and the pro-competitive rail steering committee. And I suggest that those two entities, coal and the pro-competitive rail steering committee, probably accounts for a third of the entire freight revenues in the industry.

So we are not just a small group of shippers. And when we realize that we make up an important part of the industry and we are willing to talk about a highly specialized bulk transportation system, we are big enough so that there is a base there to support it.

But we do not think that all that has to be shed. We think there are revenue adequate railroads who could in fact have lower rates for captive traffic without driving the competitive traffic off the system.

Senator ROCKEFELLER. Thank you.

Senator Exon [presiding]. Gentlemen, Senator, thank you very much.

I apologize to everyone for having to go to the floor. I will read your testimony in the record.

I want to ask each of you to comment on a couple of questions, and then I will thank you for coming here and helping us out today. You testified earlier to the fact that the railroads had reduced the cost of shipping grain by 44 percent since deregulation, and the reduced rates of coal were about 6.9 percent or some figure about in that area.

I appreciate very much the fact that the railroads have records indicating they have reduced the rates for grain by 44 percent, which is certainly good for a grain producing state like Nebraska, and we produce no coal.

Since both of you obviously have done some studies and have some knowledge about the railroad industry, can you explain to me why it would be that grain rates have gone down 44 percent and coal rates something around seven percent? I do not understand that.

Is that the way the different railroads operate? On its face, it would seem that they are not interested in the coal business, but our grain business. Is coal that much more expensive than grain to ship?

What are the possible reasons for that?

Mr. VOYTKO. May I take the first crack, and then I will defer to my colleague.

First of all, trends in rail rates are strongly affected by what the market demands. The numbers you cite are not my figures. They are the AAR figures. But I am aware of them.

I think that the movement downward in grain rates in real terms by 44 percent, in nominal terms, that is the actual dollars, by 27 percent, and smaller reductions in coal rates really says something about one of the key provisions of the CURE bill, that is the prohibition of the consideration of geographic competition. These two markets—the global grain and coal markets— probably have given your state, Nebraska, and your state, West Virginia, and our country one of the most smashing examples of geographic competition you would ever want to see.

In the export coal market, for instance, we are now not only competing with South Africa, Australia, Poland, traditional exporters of coal, but also all of a sudden British Columbia, China and Colombia. When a mine in West Virginia goes to sell into this world market, whether it moves the coal to Tidewater by Norfolk Southern or by CSX, it is facing an immense amount of geographic competition.

Even if there were only a single mine in all the United States that was designed to sell into the export market, I doubt that they could get all that much better a price because of that geographic competition. It is a commercial reality there and in the railroad business, too.

Much the same way for grain. I am sure that you have read, Senator, about the surpluses of grain and the exports coming out of very unlikely places, like India and China. Again, a smashing example of the potency of geographic competition. This is one of the factors the railroad industry has to face which gives some shippers who appear to be captive actually more economic leverage, competitive leverage, than it would seem.

Senator ROCKEFELLER. Mr. Chairman, could I just interject one comment there?

Senator EXON. Certainly.

Senator ROCKEFELLER. There was testimony by the Danish utility executive Kai Bograd at the U.S.-European Coal Conference on American coal shipped from the East Coast, and he pointed out that the cost of mining had gone down about 42 percent, the cost of terminals, handling terminals, had decreased about 40 percent, the cost of ocean freight had gone down about 29 percent, and the cost of railroads had gone up 15 percent.

Senator EXON. There is a story about people and figures that I will not tell at this time.

Dr. Cooper.

Dr. COOPER. Well, I will actually pick right up where that left off, and I think I have looked at the testimony on the House side. And I think the AAR divides the current price of—the current rates by the rail cost index, which is not adjusted for productivity, a major point of contention before the Railroad Accounting Principles Board.

And so the index overstates rail costs and therefore overstates the amount of reduction. And the overstatement is a good 15 or 20 percent. So I believe they divided by the wrong indicator.

Senator EXON. Well, Dr. Cooper, are you telling me——

Dr. COOPER. I am not saying they have gone up. I am saying there is a misstatement of how much they have gone down in "real terms, "because the real is not everybody's real, the GNP deflator. It is the rail industry's deflator, which has not been adjusted for productivity.

Senator EXON. Maybe I should have told that story, then.

Dr. COOPER. It is not my index that is divided by the wrong number.

Why the difference between coal and grain? It is market power to a significant extent. Grain is a bit more competitive, is considerably more competitive. The grain market has been a lot softer.

But in addition, I would suggest that the reduction is uneven. And I will submit for the record, since the AAR offered to present some testimony about the State of Kansas, I will submit from the current issue of Rand Journal of Economics a study of grain rail rates.

Essentially what the study found, for instance, is that using the wheat coefficiencies, which is the terminology, I find that shippers who are 400 miles from water competition pay rates 40 percent greater than those who are 100 miles away.

So if you have water competition nearby, you are paying much lower rates. And this is based on the 1983 waybill sample. You might think about how Nebraska stands vis a vis water competition.

The study also found that if you had more railroads serving you, you pay considerably lower rates as well, evaluated again at the mean of other values. A movement from monopoly, that is with one railroad, to a duopoly, that is with two equal sized railroads, in corn leads to an 18 percent decline in rates.

And if you move to a third railroad, more competition, you get another 11 percent decline. So monopoly power, market power, is out there. It can be an exercise, and it would be interesting to see, if you looked at the State of Kansas, how many railroads and how much water competition is affecting their rates.

Mr. VOYTKO. I think Rand has rediscovered the value of a good piece of bottom land.

Senator EXON. The question has come up and statements have been made to me that, even if you hauled coal at no cost, at no transportation cost from the mine and after it was loaded just hauled it free to a port, that most U.S.-produced coal could still not compete in the international marketplace with some of the countries that you mentioned, Mr. Voytko.

Do you think that is an accurate statement?

Mr. VOYTKO. I do not know whether that is true or not. I do know that South Africa, for instance, and Australia are extremely competitive on coal prices.

Senator EXON. Are they subsidized by their government?

Mr. VOYTKO. Well, to the extent that apartheid in South Africa perhaps has an effect on lower labor costs.

Senator EXON. No, we do not have apartheid. That is just one country, I guess.

Mr. VOYTKO. And I do not know the answer as to whether or not Australia provides any infrastructure subsidization. I do know that it is a free market globally for export coal shipments.

I think you will find that Mr. McKinnon of Norfolk Southern or Mr. Snow of CSX will tell you that if the mines on their railroad lines, are not competitive in the market, they do not haul any coal. And if you want to see something that will bring a railroad's earnings down faster than anything else, it is not hauling any traffic but having to pay for all the infrastructure.

Senator EXON. Do you have any comment on that, Dr. Cooper?

Dr. COOPER. Well, I will leave the coal industry to defend its mine mouth prices. I think they will do a good job of showing that they have in fact reduced their mine mouth prices.

I think it is an awful lot cheaper to compete if you do not have a significant amount of monopoly rent being collected on the transportation of coal. And with respect to what the characterization of the railroad industry, at least on the House side, that nobody is captive, we are all in this together, I will offer two observations.

One, the telephone companies often tell us that. They say: No one is a captive; you can write a letter. You can drive across town to talk, so you always have a substitute, and why would we raise rates?

But that is what monopolists do. They look at how much they can make and they maximize their profits. And if they lose a little bit of sales—if the assumption was that no monopolist would raise prices above costs for any reason ever, then we would have no basis for most economic and antitrust regulation and intervention in the marketplace.

And frankly, we believe that there is a legitimate concern about market power, particularly in an industry where studies have found people to be captive. And so, yes, they will look at a rate and say, we do not want to quote that rate, we do not make enough profit on that, and they lose that piece of business, in order to maintain and pursue higher rates elsewhere.

Senator EXON. Mr. Voytko, for the first five or six years of the Staggers Act the ICC, according to the information that I have collected, did not recognize in any ruling that there was such a thing as a captive shipper. Recently, they have made one, two, and maybe three decisions that would recognize the fact that there is such a thing.

Could you imagine a scenario where five years would go by after the Staggers Act was passed and signed into law by the President that we would not have one case where the ICC stepped in to protect a captive shipper? Would you think that possibly the ICC under that kind of scenario may not be looking at captive shippers as the Congress had intended?

Mr. VOYTKO. Mr. Chairman, putting aside the debate as to what is a captive shipper and whether there are any and if there are how many or how few there are, if you went for a three or four or a five year period and none were recognized, it might mean that none exist.

It might mean that the definition was incorrect, it might mean that the agency was just poorly managed, or it might mean that shippers were opting instead for other avenues of redress, such as the negotiation of long term contracts. On this latter point I understand—but I do not know the actual figures on this—that the number of coal contracts and certainly the number of total rail contracts in the industry vastly outnumbers the number of contested maximum rate cases filed with the Commission over that period.

So it could mean any one of those things. I just do not know which one it would be.

Senator EXON. Do you agree with that answer that I received from Mr. Voytko, Dr. Cooper?

Dr. COOPER. Well, the ICC actually recognized them as captive, because they have had their market dominance proceedings and the success rate has been pretty high, that is getting yourself declared to be market dominant. What they had not done until the recent period is give them any relief.

Senator EXON. Well, they were supposed to under the general interpretation that I had and I think that most people had with regard to the Staggers Act. The ICC was supposed to act to protect captive shippers. They did not for the first five years of this piece of legislation.

Dr. COOPER. They did not, even though they admitted that there were captives out there. They took time in developing their coal rate guidelines, an endless time, some of us thought. And they developed a guideline that we think ultimately is not in and of itself the basis for reasonable rates.

It is a consideration. You can put stand-alone costs in, but you ought to look at the actual cost of service to have some idea.

One other point I would like to make is, with respect to product and geographic competition, those are nice legitimate theoretical concepts. But when you see them abused, as we have frequently by the ICC, you have to make a choice about whether or not you will leave that door open to being abused.

And having, as Mr. Tauke on the House side, farmers told that, as long as you can send your grain to feed you have got an alternative, a geographical alternative instead of sending it to market and that can be a threat of a form of competition, as long as oil shippers in the Rocky Mountain States were told, truck it in, that is a form of intermodal competition, you have abuse of the concept to define whether people are captive.

And we think you ought to let people into the agency to get protection, rather than exclude them.

Senator EXON. Gentlemen, thank you very much, Mr. Voytko, Dr. Cooper. We appreciate your coming here. You have contributed a great deal to our hearing this afternoon. We thank you.

We are adjourned.

[Whereupon, at 4:35 p.m., the subcommittee was adjourned.]

RAIL INDUSTRY/STAGGERS ACT OVERSIGHT

WEDNESDAY, JUNE 17, 1987

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
SUBCOMMITTEE ON SURFACE TRANSPORTATION,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:30 a.m., in room SR-253, Russell Senate Office Building, Hon. J. James Exon (chairman of the subcommittee) presiding.

OPENING STATEMENT BY SENATOR EXON

Senator EXON. The subcommittee will come to order.

Today's hearing is the second in the surface transportation subcommittee series of three hearings on the rail industry and the Staggers Act.

Last week we heard from the witnesses who testified regarding the financial health of the industry. I suspect that we may be hearing more about that today from some of the witnesses.

Today we will spend the majority of our time considering the ICC's implementation of the Staggers Act. We will also hear from a panel of railroad executives in continuation of the inquiry that we began last week into the financial condition of the rail industry in general.

Next week the subcommittee will devote attention to specific proposals to amend the Staggers Act. During that hearing we will receive detailed testimony on the Consumer Rail Equity Act introduced by Senator Rockefeller.

As we hear from the witnesses scheduled to testify today, I will be interested in knowing more about what the ICC is doing in terms of revenue adequacy, rate reasonableness, competitive access and management of its docket; labor protection for rail workers; and sales to short line and regional railroads is also an area that has received considerable attention.

These are issues which have been the source of considerable controversy, and are of particular interest to the subcommittee.

These are also important issues to this individual Senator, as a representative of the State of Nebraska, I am especially interested in hearing testimony on how the Staggers Act of 1980 and the ICC action since that time have affected the level of rates and service for shipment of agricultural commodities.

This subcommittee heard testimony from the railroads at its last hearing that from 1980 to 1986 railroad train rates dropped by about 44 percent in constant dollar terms.

I would like to know who has been the beneficiary of these savings the railroads say have occurred. To what extent, if any, have these savings been passed on to the grain shippers and grain farmers?

Secondly, as a transportation corridor state, railroad employment has been a very important matter to Nebraska. I would like to hear from the railroads, particularly Union Pacific and Burlington Northern, what they think the future holds for their employees.

After any opening statement from other members of the subcommittee, I will call upon our first witness, Chairman Heather Gradison of the Interstate Commerce Commission.

With that, I will be glad to recognize my colleague from Oregon for any opening remarks that he has.

Senator PACKWOOD. No statement, Mr. Chairman.

Senator EXON. Senator Rockefeller?

OPENING STATEMENT BY SENATOR ROCKEFELLER

Senator ROCKEFELLER. Thank you, Mr. Chairman. I am again grateful to you for the second day of hearings.

The first one had to do with the health of the Nation's railroads, and I think that the record clearly demonstrates from that first hearing that the major coal hauling railroads are financially sound and that they are financially prosperous.

Today we look at the Interstate Commerce Commission's performance itself in implementing the Staggers Rail Act of 1980.

Having very closely scrutinized the ICC's action, or better yet, inaction, under the Staggers Act, I can only put it very bluntly and very succinctly, Mr. Chairman. I am appalled by what I see.

As shippers and consumers, we supported the Staggers Rail Act 7 years ago because we wanted dependable, healthy, safe and profitable railroads.

Congress said that the ICC should let the marketplace work. It has. Some shippers it has particularly worked for. For many shippers of bulk commodities, especially coal shippers in my State of West Virginia, it has not worked at all.

Congress directed the ICC to be vigilant in protecting those shippers that would be left vulnerable to railroad monopoly power in a largely deregulated marketplace.

We did not sanction a system of meaningless protection by an agency of the Federal Government. We did not direct the writing of financial criteria that would saddle shippers with unreasonably high rates because of the ICC's absurd notion of railroad revenue requirements.

And we did not direct this agency to consume seven years in not developing a rate reasonableness standard that is predictable and reliable.

Mr. Chairman, the coal industry of my State of West Virginia, and shippers of bulk commodities throughout the nation cannot wait for the Interstate Commerce Commission any longer.

This is the year for this committee and this Congress to do deal with this problem; to come to the aid of shippers; and to restore the original balance intended by the Staggers Rail Act.

This committee and this Congress must bring tangible and lasting relief to shippers who face regulatory neglect at the hands of the Interstate Commerce Commission.

I look forward obviously to this hearing today, and again, I thank you, Mr. Chairman.

Senator EXON. Thank you, Senator Rockefeller.

The Senator from South Dakota.

OPENING STATEMENT BY SENATOR PRESSLER

Senator PRESSLER. Thank you, Mr. Chairman.

I can certainly identify with many of the remarks of my friend from West Virginia.

A principal interest I have is regional and short-line railroad development. That is an issue important to my state. These smaller lines are filling a void in rural America left by Class I railroad abandonments.

And that does not necessarily mean they have to be opposed to the large railroads. They are synergistic in the sense that if there are more jobs on short lines, there are going to be more jobs on main lines.

And if there is more traffic on short lines, it is going to feed into main lines.

However, there are some issues where conflicts might arise. There are also labor issues.

I am not unfriendly to labor, but there has to be flexibility for short line railroads. So I shall be listening and watching how that issue develops throughout this process.

My observation is that all these deregulation bills have had a devastating effect on my State of South Dakota, be it airline, motor carrier, or railroad deregulation.

But, nevertheless, this is past history. And we are starting over today. We are in 1987, and we have to deal with the situation as best we can.

So I wanted to make the point, Mr. Chairman, that I think the health of the whole railroad industry in our country depends on regional and short line railroads prospering. And I think we should very carefully tailor whatever we do along those lines.

Thank you.

Senator EXON. Thank you very much, Senator Pressler. Senator Kasten, the ranking member, do you have a statement?

OPENING STATEMENT BY SENATOR KASTEN

Senator KASTEN. Thank you, Mr. Chairman. Today we turn to a subject that has generated considerable controversy—the Interstate Commerce Commission's implementation of the Staggers Act. Congress intended that the Staggers Act be used to enable the railroads to rebound from their near collapse of the late 1970's. The news in that regard is good. We heard testimony at last week's hearing indicating that the Staggers Act has helped the railroads improve their financial health.

Another purpose of Staggers was to provide protection to captive shippers. The ICC's efforts to provide this protection have been hotly debated.

There is little question that many rate cases have languished far too long at the Commission. In the last year, however, the ICC has rewritten its coal rate guidelines and applied them in several major rate cases. Last month, the ICC issued proposed rate guidelines for small shippers and applied them in a tentative decision involving Montana grain. The Commission has also adopted guidelines on the cancellation of joint rates and other competitive access issues. These guidelines were developed with the assistance of the railroads and shipper groups.

Despite these actions, criticism of the ICC has continued. Critics contend that the Commission's coal rate guidelines and its application of those guidelines are biased toward the railroads. Some shippers claim that the new competitive access rules provide them inadequate protection and must be rewritten.

Mr. Chairman, I look forward to our review of the Commission's record with Chairman Gradison and to the testimony of railroad executives, rail labor and shippers on the Commission's record.

Senator EXON. We will now move on to our first witness. And before I introduce her, I want to tell her that I must leave for a few minutes to go over to Senator Byrd's office on another minor problem that we have in the Federal Government today, and that is with regard to the formation of a Federal budget, which is not nearly as important as the railroad industry, but it has some adverse affects on the overall economy.

So I will have to step out for a few moments. But I am very pleased at this time to call upon Hon. Heather Gradison, Chairman of the Interstate Commerce Commission, who has graciously come over to give us her views on this very important subject this morning.

So Madam Chairman, will you please proceed?

STATEMENT OF HON. HEATHER J. GRADISON, CHAIRMAN, INTERSTATE COMMERCE COMMISSION, ACCOMPANIED BY RICHARD H. KLEM, DIRECTOR, OFFICE OF TRANSPORTATION ANALYSIS; JOHN F. HENNIGAN, JR., CHIEF OF POLICY; AND DAN CAMPBELL, DEPUTY GENERAL COUNSEL FOR LEGISLATION AND RESEARCH

Ms. GRADISON. Good morning. Thank you, Mr. Chairman.

I would like to introduce the panel with me. On my far right is Deputy General Counsel Dan Campbell. On my right is John Hennigan, Chief of Policy for the Interstate Commerce Commission. And on my left is Dr. Richard Klem, who is our new director of the Office of Transportation Analysis.

Copies of the Commission's completed statement have been supplied, and I would like to summarize the main points.

The Staggers Rail Act has been an extremely successful law. It was designed to prevent the collapse of the rail system; to reverse a long trend of decline.

Where earlier reform laws had failed, Staggers succeeded by giving the railroads the flexibility to manage their own affairs.

The ICC was retained as a backstop, a presence necessary to prevent abuse. Seven years after enactment, we think it is evident that the market is doing its job, and that the ICC is also doing its job as well.

We have been the subject of a tremendous amount of debate, but I think the record of the last 18 months demonstrates that we can adjust and fine tune so that the balance intended by Staggers can be preserved.

Railroads are healthier today, but their health has not come at the expense of shippers. Shippers have been winners too. Rail rates measured in constant dollars have been falling since 1981 after steadily rising over the previous decade. While rates were falling, rail profitability improved modestly, but most of that modest improvement has been enough to permit revitalized investment and improved service.

The average speed of trains, falling in the years before Staggers, is rising again.

The end of stifling regulation has given birth to customer-oriented marketing. There were nearly 79,000 tariffs filed in 1986, and mutually satisfactory contracts continue to come in at a rate of about 1,000 a month.

This is in marked contrast to the pre-Staggers pattern of reliance on collectively set general rate increases.

Everyone seems to agree that Staggers is working. The dispute is over the Interstate Commerce Commission's implementation. Our alleged failure to backstop the few shippers who are not protected by the market.

But the record of the last 18 months is not a record of neglect. It is a record of hard work aimed at establishing balanced regulation.

I would like to review that record for you this morning. In 1986, the Commission began implementation of its maximum coal rate guidelines. These were regrettably a long time in coming, but in the first application, the Commission authorized a $20 million refund to a Nebraska utility.

In a second application just now decided, another large reparation has been made. In yet another high profile coal dispute, the Commission awarded $50 million as a refund to satisfy one of a series of complaints brought by the City of San Antonio.

The remainder of the city's complaints have been settled by the carriers for an additional $60 million—money that represents a clear judgment by the railroads that our coal rate guidelines put them at risk.

The city of San Antonio expressed its appreciation for the time, effort and patience and energy dedicated to the case by the Commission.

Coal shippers have been given leverage by these Commission actions. Longstanding disputes are now being settled, in some cases with payments of sizable money damages.

Coal is increasingly moving under contract, with shippers claiming savings in tens and hundreds of millions of dollars over the life of the contract.

These developments are the cumulative effect of the Commission's commitment to competitive entry and to a maximum rate policy that effectively protects captive shippers.

We're actively seeking to expand the availability and reduce the cost of our maximum rate protection as well. In 1986 we opened a proceeding to ask for suggestions from shippers about streamlining maximum rate cases.

Simplified proposals are now out for comment, but we are already using the proposals.

Two years ago, much of the burden of proof in complicated market dominance disputes was shifted to the railroads. Combined with this shift of burden to the rails, new noncoal rate guidelines for small shippers will make rate relief readily accessible for all captive shippers, regardless of their size.

For the past 18 months the Commission has been actively reviewing, fine tuning, if you will, other important regulations. Across the board rate relief was given in an adjustment to our rules for price indexing.

In October 1986, the Commission ordered a roll back in rates that had been automatically increased under a price index provision of the Staggers Act, but which had not decreased when the costs of railroading declined.

In addition, the Commission revised its revenue adequacy standards in response to valid criticisms of handling of deferred taxes and other accounting issues.

Our new rules are fully supported by the GAO and the proposed findings of the Railroad Accounting Principles Board.

In changing our rules, we adopted two out of the three major proposals offered by our critics. The one we did not adopt, embedded debt, would not make any difference in the outcome.

There is no defensible revenue adequacy standard that would produce a lot of revenue adequate railroads. The industry simply is not that profitable; 34th out of 40 major industrial sectors.

But the absence of a revenue adequate label is not critical to maintaining a balance. To reiterate, in the past 18 months, we ordered in excess of $80 million in reparations, and in each case, the penalized carrier was revenue inadequate.

Revenue inadequacies simply does not translate into a license to do as you please. Staggers recognized that competition was a partner with rate freedom, and the Commission concurs.

The ICC actively promoted competitive access in 1986. We have been an aggressive supporter of new competition for Powder River coal, twice approving in 1981, and in 1986, the expansion of a second railroad into the region.

These decisions have had favorable implications for energy pricing throughout the nation. New construction was also authorized to coal reserves in Montana and New Mexico.

We approved trackage rights, make the Soo line a new competitive force for traffic flowing through Detroit, Michigan.

We granted trackage rights to the DRG and the MKT to enhance competitiveness in the Central States corridor.

In the first several applications of our new competitive access rule, the Commission suspended cancellations of joint rates.

Finally, we ordered Conrail to renegotiate new rates for a broad array of joint line services that had been canceled.

These decisions reflect our commitment to a responsible competitive entry policy. Despite this favorable record on competitive access, criticism centers on one decision in which we denied mandatory switching and mandatory trackage rights to a shipper.

The decision found that no abuse of competition had occurred. This was a factual determination, one made on an extensive record.

What we saw when we looked was a shipper expanding its markets and its reliance on the service by the very carrier it sought to penalize.

We could not find any record for granting relief except the belief of the shipper that it would be better off with a second carrier.

We think that you, the Congress, rejected a mandatory two-railroad policy in 1980, and we know that the rail and shipper parties to our new access rules rejected it in 1985. And we did not reverse course in this isolated case.

We have been working hard to fulfill our mandate under the Interstate Commerce Act. Our docket has been crowded with important cases. We are scheduled to hold an open conference on the issue of reopening the Santa Fe-Southern Pacific merger on June 30th.

Cases such as this take a substantial bite out of our time and resources, but we also have handled a host of smaller cases.

In 1986, we issued 14,154 procedural and substantive decisions for all modes.

Approximately 13,000 new applications were brought before the Commission, most of which were decided within six months of receipt.

By and large, our performance seems to be judged by our rate cases. This focus may create a false impression. The problem is not that big. We had three cases filed last year. We have had none filed in 1987, and we are now able to move the cases much more rapidly.

Of the more than one million tariffs filed, almost 79,000 were filed by rail carriers. Shippers complaints and protests against new rail rates numbered no more than two dozen. We had only two dozen protested, rates.

The backlog of rate cases is half of what it was 15 months ago, and we have energetically encouraged parties to settle their differences.

Where final rate determinations have been made, we have ordered reparations for shippers four out of five times. No complaints against reasonableness of existing rates; and only one protest of a new rate have been filed so far in 1987.

I would like to change topics and talk about new railroads instead of old rates. One of the most pleasant developments in the past few years has been the development of short line and regional operators that have made possible the preservation of jobs and service in many areas where abandonment would have been certain under the old regulatory regime.

These carriers now operate about 10,000 miles of track, and have over 3,000 employees.

The Commission has supported this development with efficient regulation that encourage applicants to think of the market, not the government.

We continue in a backstop role, and will exercise our authority where problems can be demonstrated. But we should not stress problems here.

This is an area where Congress and the country received an unexpected gain from deregulation. An industry has cropped up to serve customers that were looking abandonment in the eye.

Overall, we have a good record of accomplishment. But in hearings last month it was argued that the Commission cannot be trusted; that our actions are designed to influence Congress; that we make promises we cannot keep.

Here is our record. We promised we would review our revenue adequacy standards, and we did.

We promised we would look at recent increases under the RCAF, and we did.

We promised to come up with new, fast, and less expensive rate reasonableness rules for a small shipper, and we did.

We promised to move our coal rate docket with standards developed under Ex Parte 347 sub 1, and we did.

I admit to a bit of excess optimism about moving rate cases. It is amazing how often due process can become undue process.

Nonetheless, I am proud of our performance. We have decided a handful of tough cases. We have made market dominance decisions in nearly a dozen more.

And as I said, the rate docket has been cut in half. We have only about two dozen cases to go, and we will reduce the number further this year.

We seem to be cranking the cases out about one every three months.

Over the past year we have made a number of adjustments where criticism seemed valid. Indeed, shippers now have much of what the early version of reform legislation sought.

The early reform legislation suggested they were seeking fine tuning. The Commission suggests we have done the fine turning. But while we have adjusted, we have drawn the line to protect the vital achievements of the Staggers Act.

I do not believe it is possible to argue much longer about fine tuning. The proposed legislation I have seen is an aggressive attack on the Staggers Act concept that rates should be regulated only in the absence of effective competition.

It contains competitive access concepts that in the words of a recent court decision, would work a radical restructuring on the rail industry.

It would change the government's role from backstop to umpire, once again, in on every play.

It is the Commission's view that the Staggers Act has worked well for the country, and the proposed bill risks much of that gain.

I appeared before you over a year ago. And at that time, I gave you heartfelt assurances that things were under control at the Interstate Commerce Commission. Our record today shows just that.

Legislation at this time would be difficult for the industry to absorb, and frankly, irresponsible on the part of the Congress. My husband said those were tough words to use, but I believe it.

I urge you not to make the same mistakes which led to the dire need for Staggers, because I believe that you will not get a second chance.

That concludes my opening remarks. Thank you for your patience in extending my time.

Senator ROCKEFELLER [presiding]. Thank you, Chairman Gradison.

Chairman Gradison, I want to try to get a number of questions on the record. And that puts you in the position, if you answer at great length, of subtracting from my time.

Ms. GRADISON. I will keep that in mind.

Senator ROCKEFELLER. So I hope we can work mutually here, insofar as possible.

When you appeared before this committee before, you said that the revenue adequacy test of the ICC was broken and that it must be fixed.

The ICC has made some changes, but whether it is fixed maybe a matter of some debate on the part of some Members of this committee.

At this point which railroads are revenue adequate?

Ms. GRADISON. We do not have any revenue adequate railroads. No carriers are earning the current cost of capital.

Senator ROCKEFELLER. All right. I remain a little bit confused, then. The annual reports of the railroads say they're doing very well. Their 10K submissions to the SEC say they are doing very well. It is just one litany after another of extraordinary healthy railroads.

How can that be?

Ms. GRADISON. How can that be? The rail industry is 34th out of 40 of the major industrial sectors. They are not making that much money.

The old expression of a passbook savings account would provide a better rate of return than having your money in the rail industry. That is why we have seen this tremendous disinvestment, investment in other industries.

I will keep my answer brief.

Senator ROCKEFELLER. The reports, nevertheless, to the Securities and Exchange Commission, reflect nothing about revenue inadequacy. They seem to feel that they must be doing fairly well, the railroads.

You have no way of explaining why they would not say that the ICC says that they are revenue inadequate?

Ms. GRADISON. Their rate of return is not that good. If I were doing a listing at the SEC, I would not say, put your money in a passbook savings account instead of my company. But that is the truth.

There is less risk in a passbook savings account. The government does not regulate entry. The government does not regulate exit. If you have an unprofitable investment in a passbook savings account, if the bank has an unprofitable investment, they can get out of it.

If a railroad has an unprofitable line, it has to come to the Interstate Commerce Commission to get permission to abandon that line.

Senator ROCKEFELLER. In your dissent in the Santa Fe-Southern Pacific merger case, you said at that time, Southern Pacific transportation carries little coal, a key rail captive commodity that is vital to the financial health of most of the nation's financially sound rail systems.

The words, "financially sound', were yours.

My question is, Which railroads do you consider to be financially sound, even if you do not consider them to be revenue adequate?

Ms. **Gradison**. Well, the question I believe deals with solvency as opposed to revenue adequacy. Just because a carrier is not earning the current costs of capital does not mean that it is bankrupt. It does not mean that it is going to go bankrupt tomorrow.

Hopefully, the potential for earnings is good enough that the carriers will continue to invest in their systems.

Senator **Rockefeller**. My question was, which railroads do you consider to be financially sound. You used that phrase yourself.

Ms. **Gradison**. I would be happy to provide that for the record. The Commission has an analysis of the earnings of the carriers on an annual basis. I would be happy to submit it for the record.

Senator **Rockefeller**. Would you please do that? Thank you.

[The following information was subsequently received for the record:]

Interstate Commerce Commission
Washington, D.C. 20423

July 17, 1987

OFFICE OF GOVERNMENT
AND PUBLIC AFFAIRS
(202) 275-7231

Mr. Lloyd L. Beasley, Jr.
Printing Clerk
Senate Committee on Commerce, Science,
and Transportation
508 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: Hearing No. 32

Dear Mr. Beasley:

Attached is additional information that Chairman Gradison promised for the record during her testimony on June 17, 1987 before the Surface Transportation Subcommittee (on page 22 of transcript).

Please let me know if you have any questions.

Sincerely yours,

Alexander H. Jordan
Director

The Commission publicly releases a report each quarter showing the latest earnings and traffic volume of the Class I railroads. The following is the Commission's most recent report (with accompanying news release) which compares Class I railroad earnings for the years 1986 and 1985. The report does not categorize the railroads as to quality of financial condition, since public disclosure by a government agency that a company is not financially sound could further adversely affect its financial posture. However, financially strong railroads are those which generally report consistently strong profits. Based upon a review of earnings data for the past few years, financially sound railroads include, but are not limited to:

Atchison, Topeka and Santa Fe
Burlington Northern
Consolidated Rail Corporation
CSX Transportation
Norfolk and Western
Southern Railway
Union Pacific

INTERSTATE COMMERCE COMMISSION
BUREAU OF ACCOUNTS
WASHINGTON, D. C. 20423

SHEET 1 OF 9

CLASS I FREIGHT RAILROADS SELECTED EARNINGS DATA

(000 OMITTED)

District, Railroad and Year		QUARTER ENDED DECEMBER 31					TWELVE MONTHS ENDED DECEMBER 31					
		Railway Operating Revenues	Net Railway Operating Income a/	Income Before Extra-ordinary Items b/	Net Income c/	Revenue Ton-Miles of Freight	Railway Operating Revenues	Net Railway Operating Income a/	Income Before Extra-ordinary Items b/	Net Income c/	Revenue Ton-Miles of Freight	Return on Net Investment d/ (Percent)
EASTERN AND SOUTHERN DISTRICTS.....	1986	$3,037,624	$ 138,837	$ 332,721	$ 366,569	81,007,584	$12,224,481	$ 746,043	$ 979,687	$1,095,089	330,973,685	4.22
	1985	3,175,381	(124,973)	(119,997)	(103,015)	84,943,415	12,918,018	731,194	827,538	917,500	339,649,909	4.24
WESTERN DISTRICT..................	1986	3,428,773	(418,202)	(368,472)	(367,128)	140,680,133	13,968,952	(232,896)	(230,047)	(548,007)	543,268,295	-0-
	1985	3,575,904	236,629	286,056	285,931	131,209,508	14,736,041	984,056	1,012,155	1,015,564	535,798,288	5.96
TOTAL ALL CLASS I FREIGHT RAILROADS	1986	6,466,397	(279,365)	(35,751)	(559)	221,687,717	26,193,433	513,147	749,640	547,082	874,241,980	1.46
	1985	6,751,285	111,656	166,059	182,916	216,152,923	27,654,059	1,715,250	1,839,693	1,933,064	875,448,197	5.08
Individual Railroads Data Eastern and Southern Districts												
Boston & Maine	1986	23,851	(456)	4,946	4,946	416,945	85,203	(6,269)	3,565	3,565	1,650,748	-0-
	1985	28,037	(23)	1,756	1,756	538,161	115,708	1,447	4,286	4,286	2,303,016	2.09
Consolidated Rail Corp.	1986	777,781	69,140	84,179	119,110	19,201,899	3,088,125	279,693	315,689	431,091	74,613,689	5.37
	1985	770,186	85,648	97,845	112,066	18,746,425	3,153,648	309,064	360,854	441,809	74,131,725	6.23
CSX Transportation e/, f/	1986	1,135,069	41,229	78,831	78,831	31,031,680	4,528,849	342,930	329,310	329,310	132,808,550	5.55
	1985	1,168,561	(313,514)	(357,521)	(357,521)	33,376,000	4,772,575	(4,624)	(73,759)	(73,759)	134,053,000	-0-

CLASS I FREIGHT RAILROADS SELECTED EARNINGS DATA
(000 OMITTED)

SHEET 2 OF 9

District, Railroad and Year stern and Southern Districts (Continued)	QUARTER ENDED DECEMBER 31					TWELVE MONTHS ENDED DECEMBER 31					
	Railway Operating Revenues	Net Railway Operating Income a/	Income Before Extra-ordinary Items b/	Net Income c/	Revenue Ton-Miles of Freight	Railway Operating Revenues	Net Railway Operating Income a/	Income Before Extra-ordinary Items b/	Net Income c/	Revenue Ton-Miles of Freight	Return on Net Investment d/ (Percent)
elaware & Hudson 1986	$ 17,329	$ (6,197)	$ (5,405)	$ (5,405)	695,078	$ 80,381	$ (11,705)	$ (13,447)	$ (13,447)	2,630,219	-0-
1985	27,325	(1,204)	(1,102)	(1,102)	853,755	109,640	(3,113)	(3,559)	(3,559)	3,647,399	-0-
Florida East Coast 1986	34,612	4,985	12,285	12,285	926,950	121,177	11,360	25,441	25,441	3,648,948	7.06
1985	31,589	4,535	6,543	6,543	840,884	117,788	9,284	23,632	23,632	3,227,081	5.20
Grand Trunk Western 1986	78,934	(21,497)	(22,598)	(23,681)	1,347,463	323,030	(26,504)	(16,446)	(16,446)	5,152,168	-0-
1985	87,565	1,355	854	2,235	1,261,731	342,947	5,294	1,414	6,130	4,980,991	1.59
Illinois Central Gulf f/ 1986	146,180	4,302	38,181	38,181	4,691,000	679,488	(189,774)	(171,674)	(171,674)	18,922,000	-0-
1985	208,078	6,879	15,523	16,903	6,383,171	880,518	33,256	25,677	29,968	25,747,171	2.04
Norfolk & Western 1986	414,447	11,265	98,003	98,003	11,044,862	1,639,944	127,477	290,050	290,050	44,284,253	6.81
1985	434,026	42,687	63,369	63,369	11,125,151	1,720,856	170,397	281,306	281,306	44,165,616	9.03
outhern Railway 1986	409,421	36,066	44.299	44,299	11,651,707	1,678,284	218,835	217,199	217,199	47,263,104	8.36
1985	420,014	48,664	52,736	52,736	11,818,137	1,704,338	210,189	207,687	207,687	47,393,910	9.24

CLASS I FREIGHT RAILROADS SELECTED EARNINGS DATA
(000 OMITTED)

SHEET 3 OF 9

District, Railroad and Year		QUARTER ENDED DECEMBER 31					TWELVE MONTHS ENDED DECEMBER 31					
		Railway Operating Revenues	Net Railway Operating Income a/	Income Before Extra-ordinary Items b/	Net Income c/	Revenue Ton-Miles of Freight	Railway Operating Revenues	Net Railway Operating Income a/	Income Before Extra-ordinary Items b/	Net Income c/	Revenue Ton-Miles of Freight	Return on Net Investment d/ (Percent)
Western District												
Atchison, Topeka & Santa Fe f/	1986	$ 486,385	$ (139,495)	$ (132,073)	$ (132,073)	17,092,908	$ 1,951,654	$ (51,946)	$ (62,692)	$ (62,692)	67,143,071	-0-
	1985	518,603	28,434	30,729	30,729	16,902,226	2,144,360	119,699	125,792	125,792	69,094,749	4.38
Burlington Northern f/, g/	1986	906,290	(6,670)	31,695	31,695	51,176,793	3,732,981	63,924	81,131	(254,710)	188,232,098	1.40
	1985	980,907	104,204	110,679	110,679	45,882,710	4,040,540	458,296	488,510	488,510	184,093,820	10.53
Chicago & North Western f/	1986	193,844	7,762	14,414	14,414	6,298,586	823,586	34,476	35,958	35,958	26,982,303	3.34
	1985	205,262	(17,672)	(21,279)	(21,404)	5,691,932	823,661	4,435	(29,506)	(26,097)	24,275,272	.44
Denver & Rio Grande Western	1986	60,733	1,908	6,234	6,234	2,316,236	285,273	17,910	22,731	22,731	11,131,208	4.43
	1985	77,491	5,053	6,929	6,929	2,828,794	325,463	23,495	24,051	24,051	11,643,200	5.44
Kansas City Southern f/	1986	75,657	(23,602)	(22,108)	(22,108)	2,978,348	299,912	585	(2,962)	(2,962)	11,369,420	.17
	1985	75,540	7,332	5,534	5,534	2,702,425	316,704	31,444	23,792	23,792	11,619,652	9.21
Missouri-Kansas-Texas	1986	56,127	101	2,327	3,671	2,123,198	232,695	6,282	6,781	24,662	8,099,896	1.82
	1985	57,656	675	(3,935)	(3,935)	2,135,463	263,102	7,331	(5,681)	(5,681)	8,918,065	2.21
St. Louis Southwestern f/	1986	93,027	(49,760)	(43,930)	(43,930)	3,243,800	360,631	(34,665)	(26,478)	(26,478)	12,469,378	-0-
	1985	95,336	6,763	7,698	7,698	3,206,371	390,088	17,276	21,229	21,229	13,471,856	3.13

CLASS I FREIGHT RAILROADS SELECTED EARNINGS DATA
(000 OMITTED)

District, Railroad and Year Western District (Continued)		QUARTER ENDED DECEMBER 31					TWELVE MONTHS ENDED DECEMBER 31					
		Railway Operating Revenues	Net Railway Operating Income a/	Income Before Extra-ordinary Items b/	Net Income c/	Revenue Ton-Miles of Freight	Railway Operating Revenues	Net Railway Operating Income a/	Income Before Extra-ordinary Items b/	Net Income c/	Revenue Ton-Miles of Freight	Return on Net Investment d/ (Percent)
Soo Line f/, h/	1986	$ 146,671	$ (35,727)	$ (34,945)	$ (34,945)	5,117,633	$ 606,276	$ (28,234)	$ (34,955)	$ (34,955)	19,501,900	-0-
	1985	157,131	(3,970)	4,576	4,576	5,199,230	600,373	13,102	(2,056)	(2,056)	18,342,100	4.03
Chicago, Milwaukee, St. Paul and Pacific h/	1986	-	-	-	-	-	-	-	-	-	-	-
	1985	-	-	-	-	-	48,993	(8,313)	(9,114)	(9,114)	-	-0-
Southern Pacific Transportation Co.	1986	465,195	(276,197)	(297,690)	(297,690)	15,900,631	1,909,015	(292,103)	(254,258)	(254,258)	62,534,021	-0-
f/	1985	483,245	12,969	61,802	61,802	15,062,319	2,053,880	18,344	116,976	116,976	63,501,150	.68
Union Pacific f/, i/	1986	944,844	103,478	107,604	107,604	34,432,000	3,766,929	50,875	4,697	4,697	135,805,000	1.30
	1985	924,733	92,841	83,323	83,323	31,598,038	3,728,877	298,947	258,162	258,162	130,838,424	8.03

NOTES: 1) Data shown above are based on ratable depreciation accounting for track structures (DA). By ICC order served February 17, 1983, Docket No. 36988, Alternative Methods of Accounting for Railroad Track Structures, 367 ICC 157, railroads were required to file financial data with the ICC on the basis of DA, beginning with their 1983 annual reports and 1984 quarterly reports. DA replaced the retirement-replacement-betterment accounting method for track structures (RRB).

2) This report does not include the National Railroad Passenger Corporation (Amtrak) since it is not a freight hauling railroad and is not subject to the ICC Uniform System of Accounts.

3) This report includes all Class I freight hauling railroads. The data for three Class I railroad subsidiaries of the Southern Railway Company (Alabama Great Southern Railroad Company, Central of Georgia Railroad Company and Cincinnati, New Orleans and Texas Pacific Railway Company) are included above in the data shown for Southern Railway. The quarterly data filed by the Southern Railway includes, on a consolidated basis, the data of these three subsidiaries.

4) The Elgin, Joliet and Eastern Railway Company is no longer included in this report. The Commission's Accounting and Valuation Board, on December 18, 1986, approved the railroad's request to be exempted from the Commission's Class I accounting and reporting requirements for 1986 and 1987. The exemption was granted because the railroad's total revenues fall below the minimum requirements for a Class I railroad.

Over

SHEET 5 OF 9

a/ Net Railway Operating Income - Difference between operating revenues and the total of railway operating expenses, railway tax accruals and net equipment and joint facility rents.

b/ Income Before Extraordinary Items - Net income after including fixed charges, non-operating income, unusual or infrequent items and earnings attributable to discontinued segments but before extraordinary items and cumulative effect of changes in accounting principles.

c/ Net Income - Net income after extraordinary items and cumulative effect of changes in accounting principles.

d/ Return on Net Investment - Ratio of net railway operating income to net investment in railway property used in transportation services at end of previous calendar year. The latter includes an allowance for working capital based upon the Commission's Rail Form A formula. Accumulated deferred income tax reserves have been subtracted from the net investment base in accordance with the modification approved by the Commission in Ex Parte No. 393 (Sub. No. 1), Standards for Railroad Revenue Adequacy, served December 31, 1986. If net investment data as of the end of each quarter were available, returns on investment would be computed by using an average of the net investment at the beginning and at the end of the respective twelve month periods. However, net investment data is generally only available as of the end of the calendar year; a substantial portion of this data is derived from annual reports (Form R-1) of Class I line-haul railroads which are required to be filed with the Commission by March 31 of the following year. Thus, the net investment data used for this report which represent the latest available end of calendar year data are not averaged in order to assure that net railway operating income is more closely equated, timewise, with the railroad assets generating this income. The symbol -0- for return on net investment indicates a deficit net railway operating income.

e/ Data subsequent to January 1, 1986 filed by CSX Transportation reflect the combined results of operations of the consolidated data of Baltimore and Ohio Railroad Company and Chesapeake and Ohio Railway Company and the consolidated data of Seaboard System Railroad, Inc. Previously, separate financial statements were filed by each of these three railroads. For purposes of comparability, amounts shown above for periods prior to January 1, 1986 represent combined consolidated data for these three railroads, as submitted by CSX.

f/ Net railway operating income, income before extraordinary items and net income shown above for some railroads for the quarters and/or twelve months ending December 31, 1986 and 1985 were substantially reduced due to large accounting adjustments to record severance pay for employee buyouts and the write-down of assets attributable to freight car retirements and line abandonments. The following schedule shows the affected railroads, the amounts of the adjustments (expenses less related tax benefits) and the impact on the composite Class I railroad earnings data:

	QUARTER ENDED DECEMBER 31, 1986			TWELVE MONTHS ENDED DECEMBER 31, 1986			
1986 Periods	Net Railway Operating Income	Income Before Extra-ordinary Items	Net Income	Net Railway Operating Income	Income Before Extra-ordinary Items	Net Income	Return on Net Investment
Total All Class I Freight Railroads (Per Summary on Page 1)	$ (279,365)	$ (35,751)	$ (559)	$ 513,147	$ 749,640	$ 547,082	1.46
Plus: Add-Back Total of Large Adjustments Reducing Earnings of Several Railroads (see below)	580,017	580,017	580,017	1,349,984	1,348,556	1,348,556	
Total All Class I Freight Railroads Excluding Large Adjustments of Several Railroads	300,652	544,266	579,458	1,863,131	2,098,196	1,895,638	5.29
Large Adjustments Reducing Earnings of Several Railroads:							
Railroad — Quarter Recorded							
Burlington Northern .... (Second Quarter 1986)	-	-	-	175,822	175,822	175,822	
Union Pacific .... (Second Quarter 1986)	-	-	-	356,390	356,390	356,390	
Illinois Central Gulf .... (Third Quarter 1986)	-	-	-	233,107	231,679	231,679	
Atchison, Topeka & Santa Fe ... (Fourth Quarter 1986)	164,012	164,012	164,012	164,012	164,012	164,012	
Soo Line .... (Third and Fourth Quarter 1986)	37,686	37,686	37,686	42,334	42,334	42,334	
Southern Pacific Transportation (Fourth Quarter 1986)	291,811	291,811	291,811	291,811	291,811	291,811	
St. Louis Southwestern .... (Fourth Quarter 1986)	57,339	57,339	57,339	57,339	57,339	57,339	
Kansas City Southern .... (Fourth Quarter 1986)	29,169	29,169	29,169	29,169	29,169	29,169	
Total	580,017	580,017	580,017	1,349,984	1,348,556	1,348,556	

1985 Periods	QUARTER ENDED DECEMBER 31, 1985 Net Railway Operating Income	Income Before Extra-ordinary Items	Net Income	TWELVE MONTHS ENDED DECEMBER 31, 1985 Net Railway Operating Income	Income Before Extra-ordinary Items	Net Income	Return on Net Investment
Total All Class I Freight Railroads (Per Summary on Page 1)	$ 111,656	$ 166,059	$ 182,916	$ 1,715,250	$ 1,839,693	$1,933,064	5.08
Plus: Add-Back Total of Large Adjustments Reducing Earnings of CSX Transportation and Chicago & North Western (see below)	462,960	613,147	613,147	462,960	613,147	613,147	
Total All Class I Freight Railroads Excluding Large Adjustments of CSX and CNW Railroads	574,616	779,206	796,063	2,178,210	2,452,840	2,546,211	6.45
Large Adjustments Reducing Earnings of CSX Transportation and Chicago & North Western:							
CSX Transportation	438,383	588,570	588,570	438,383	588,570	588,570	
Chicago & North Western	24,577	24,577	24,577	24,577	24,577	24,577	
Total	462,960	613,147	613,147	462,960	613,147	613,147	

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The schedule below shows for each of the affected railroads net railway operating income and return on net investment, excluding these large adjustments.

		QUARTER ENDED DECEMBER 31	TWELVE MONTHS ENDED DECEMBER 31	
		Net Railway Operating Income	Net Railway Operating Income	Return on Net Investment
CSX Transportation	1986	$ 41,229	$ 342,930	5.55
	1985	124,869	433,759	7.40
Chicago & North Western	1986	7,762	34,476	3.34
	1985	6,905	29,012	2.86
Burlington Northern	1986	(6,670)	239,746	5.26
	1985	104,204	458,296	10.53
Union Pacific	1986	103,478	407,265	10.41
	1985	92,841	298,947	8.03
Illinois Central Gulf	1986	4,302	43,333	3.69
	1985	6,879	33,256	2.04
Atchison, Topeka & Santa Fe	1986	24,517	112,066	3.93
	1985	28,434	119,699	4.38
Soo Line	1986	1,959	14,100	1.70
	1985	(3,970)	13,102	4.03
Southern Pacific Transportation	1986	15,614	(292)	-0-
	1985	12,969	18,344	.68
St. Louis Southwestern	1986	7,579	22,674	4.28
	1985	6,763	17,276	3.13
Kansas City Southern	1986	5,567	29,754	8.76
	1985	7,332	31,444	9.21

g/ The large difference between Burlington Northern Railroad Company's net income before extraordinary items and net income for the twelve months ending December 31, 1986 is attributable to a $335.8 million charge representing the cumulative effect of a change in accounting principles. This charge represents a retroactive adjustment effective January 1, 1986, of property acquisitions of prior periods to reflect a changeover to the unit method of depreciation from the composite method of depreciation. This change in method is subject to Bureau of Accounts approval.

h/ The Soo Line Railroad Company acquired the railroad operations of the Chicago, Milwaukee, St. Paul and Pacific Railroad (Milwaukee) on February 19, 1985. Data shown above for Soo Line for the fourth quarters 1986 and 1985 and the twelve months ended December 31, 1986 reflect operations over the lines of the Milwaukee. Data shown above for Milwaukee for the twelve months ending December 31, 1985 reflect operations from January 1, 1985 to February 19, 1985.

i/ Data subsequent to January 1, 1986 filed by the Union Pacific Railroad Company reflect the combined results of operations of Union Pacific Railroad Company, Missouri Pacific Railroad Company and Western Pacific Railroad Company and their subsidiaries. Previously, separate financial statements were filed by each of these three railroads. For purposes of comparability, amounts shown above for periods prior to January 1, 1986 represent combined data for these railroads, as restated by Union Pacific. Union Pacific, in its income statement for the year 1986, recorded $659.7 million of adjustments for severance pay and asset write-downs as an unusual or infrequent expense item. If these adjustments had increased operating expenses, Union Pacific's net railway operating income for the year 1986 would have been $50.9 million, instead of $710.6 million, as reported, according to the railroad's footnote disclosure. In order to provide uniformity and consistency with the reporting by other Class I railroads in 1985 and 1986 of similar costs associated with major restructuring programs, net railway operating income shown above for Union Pacific for the year 1986 has been adjusted to reflect these expenses as operating expenses. The related tax benefits ($303.3 million) attributable to these expenses had already been recorded in net railway operating income. Consequently, as shown in footnote f above, the net impact on Union Pacific's earnings from this adjustment for the year 1986 is $356.4 million (total costs of $659.7 million less related tax benefits of $303.3 million).

Senator ROCKEFELLER. Now, during the Conrail debate, it was not my general impression that the railroads looked upon themselves as being financially unsound.

They had the cash on hand to retire debts, to repair, to purchase all kinds of acquisitions, to do mergers, to buy barges, airplanes, trucking lines, all kinds of things.

And there was a litany of, we can do it, during the discussion about the purchase of Conrail. They felt themselves to be very financially viable. They came before this committee, before me and others, to say that we can buy Conrail, which at that time was deemed to be about $1.2 billion; ended up being about $1.6 billion.

Obviously, a financially unsound or revenue inadequate company would not put forward that kind of proposition.

Can you explain to me, Chairman Gradison, what you mean by the difference between financially sound and revenue adequate?

Ms. GRADISON. Yes, sir. $1.6 billion is a substantial sum, but Conrail is a large company. The government's investment alone is over $7 billion.

If Conrail had failed to sell for a substantial sum, it would have been evidence not only that it was revenue inadequate, but also, that its prospects were so poor as to risk insolvency.

Even the Milwaukee Road, which was much smaller, that was actually bankrupt, sold for $550 million, and the bankruptcy judge received a higher offer.

The $1.6 billion price for 85 percent of the company reflects the market's conclusion that the profits will be sufficient to support an investment of about $1.9 billion for the whole company.

In other words, Conrail as a whole operating railroad, is worth about $2 billion. By contrast, its book value is around $3.5 billion, almost twice as much.

This means that for Conrail the whole is worth less than the sum of the parts. A breakup into separate assets through sale or failure to replace the very thing revenue adequacy was intended to prevent is one possible result.

Indeed, the sale contract had to specifically preclude the new owners from doing either of these things.

In summary, the sale price, which is only about half of Conrail's book value, confirms the Commission's assessment that Conrail is a revenue inadequate carrier.

Senator ROCKEFELLER. Chairman Gradison, you told Congressman Boucher that the revenue adequacy test was kind of a strawman, and you said it does not make any difference whether or not a carrier is revenue adequate or revenue inadequate is not an excuse for excessive behavior, et cetera.

You basically said, it does not make any difference; it is irrelevant.

Ms. GRADISON. I did not say it was irrelevant.

Senator ROCKEFELLER. You said, it does not make any difference; it is a straw man.

Ms. GRADISON. It is a straw man in that——

Senator ROCKEFELLER. Do you believe that?

Ms. GRADISON [continuing]. In that the sponsors to promote legislation have attacked the fact that these carriers earn money, and they question how much money they make.

My point is, whether or not a carrier is revenue adequate or inadequate is not an excuse for excessive behavior.

When we look at a rate case, we try to determine whether or not it is a reasonable rate. We have our coal rate guidelines, which we have applied.

One of the considerations that we used in Arkansas Power & Light was to look at revenue adequacy. The parties did not make their case on revenue adequacy or management efficiency; they made their case on stand-alone cost.

We look at it. It is a consideration. It is a useful measure in and of itself. How are the carriers doing. But I will not back away from the point that it does not make any difference. It is not an excuse for excessive behavior, and we have proven that in all the awards we have made.

Every award we have made has been from revenue inadequate carrier.

Senator ROCKEFELLER. My final point would be that you agree that the first threshold of the coal rate guidelines is in fact that the railroad has to be revenue adequate, I am sure?

Ms. GRADISON. No, sir, it is not a threshold, it is a consideration. We look at it. Is the guy on the brink of bankruptcy.

Senator ROCKEFELLER. But you agree that it is the first of the three set parts of the coal rate guideline, revenue adequacy?

Ms. GRADISON. Yes, sir, it is one of the considerations we look at.

Senator ROCKEFELLER. Would you be in favor of our getting rid altogether of the revenue adequacy test in this legislation?

Ms. GRADISON. No, sir, it is something that we look at. The calculation has been subject to attack. The formula that we have today has been upheld by the GAO, and the Railroad Accounting Principles Board.

No matter how you calculate revenue adequacy, if you apply the CURE bill sponsor's revenue adequacy calculation, you still get all revenue inadequate carriers.

It is a useful measure to determine how railroads are doing compared with other industries, and they are not doing very well.

Senator ROCKEFELLER. Senator Packwood.

Senator PACKWOOD. Madam Chairman, you ran over very quickly some docket figures, and I cannot find them in your testimony.

When you were here a year and a half ago, there was great criticism of the docket and the delay, and I wonder if you would run them by me again slowly.

Ms. GRADISON. We handled over 14,000 cases last year. We receive about 1,000 contracts a month. We have over a million contracts in our building—excuse me, we have over a million tariffs filed a year.

The Commission has 23 coal rate cases pending.

Senator PACKWOOD. That is all?

Ms. GRADISON. We have 23 proceedings before us, 10 coal, 13 noncoal.

Senator PACKWOOD. You mean that is all the proceedings you have before you now is 23?

Ms. GRADISON. That is it, of the rate case.

Senator PACKWOOD. I understand. Of the rate cases.

Ms. GRADISON. Yes, sir.

Senator **Packwood**. How old are some of those?

Ms. **Gradison**. Some of these are as old as 1979.

Senator **Packwood**. Why?

Ms. **Gradison**. It took the Commission far too long to put its coal rate guidelines in place. We made many attempts. Each attempt went to court.

We now have 347 sub 1 coal rate guidelines in place. Those guidelines have been upheld by the courts.

We are applying the guidelines, and we are cranking out the remaining rate cases, the less than two dozen rate cases.

That is all we have before us.

Senator **Packwood**. That is quite good.

Ms. **Gradison**. That is what this whole legislative proposal is about. My rate docket is half of what it was a year ago. Last year we had over 50; this year we had less than 25.

Senator **Packwood**. How quickly, in your judgment, can you turn out a coal rate case now?

Ms. **Gradison**. Well, we found market dominance in about ten cases, and we seem to be cranking them out about one every three months.

A year from now my docket will probably be half of what it is today.

Senator **Packwood**. I did not phrase my question right. I did not mean how quickly you can churn them out. From the time they are filed, how long now, in your judgment is it going to take you to process them?

Not how quickly are you turning out the existing cases that you have.

Ms. **Gradison**. It depends on the parties. We have had some problems getting the parties to participate in the process.

For example, McCarty Farms I have got a who shot John. We have asked the parties—we have had docket management conferences, where we have sat down with the parties on both sides and said, let's move this; let us provide evidence. And frankly, I considered submitting our chief administrative law judge's transcript, because some of the representatives of shippers just thought we were joking, and they were arrogant and rude to our administrative law judge.

Because having these cases before us gives them leverage in their opinion. And it takes a lot of leverage away from me, because I am trying to get them out of the building. But we are moving them with as much speed as we can. Some of them will still take two years from this point to litigate.

And the point that I am trying to make for Senator Rockefeller and the other CURE sponsors is that if you change the statute now, you will start the process all over again.

Senator **Packwood**. Do not be defensive; I am trying to help you.

Ms. **Gradison**. I am not accustomed to that.

Senator **Packwood**. I do not think your docket is in bad shape, and I am intrigued that you have only 23 pending coal rate cases now.

And just a top of the head guess is, you think you will have maybe a dozen at this time next year.

Ms. **Gradison**. Yes, sir.

Senator PACKWOOD. Why are so few being filed?

Ms. GRADISON. Well, because our guidelines give the parties the guidelines to use to negotiate themselves. It has been said that the reason the rate cases are not filed is because it takes forever to get a result from the Commission.

We feel now that we have processed these cases, and we have seen additional settlements among the parties, that it is the guidelines that are being used for private party settlement.

And now that the carriers know what the rules are, and the shippers know what the rules are, they use it themselves rather than pursue prolonged litigation within the Commission.

Senator PACKWOOD. Thank you, Mr. Chairman. I have no other questions.

Senator ROCKEFELLER. Senator Pressler.

Senator PRESSLER. Let me turn to the issue of labor protection provisions for short line-railroads.

Currently the imposition of labor protection turns on whether the line is being sold to a railroad or nonrailroad entity.

I know that that distinction is the creature of legislative statute, so I'm not criticizing the Commission here. But does it make sense, in your judgment, to have the issue of labor protection turn on this distinction?

Should we be paying more attention to factors such as the probability of abandonment without divestiture?

Ms. GRADISON. Our goal is to preserve service and jobs. We looked at over 125 of these transactions before we implemented the Commission's class exemption.

The courts have upheld the manner in which we have approached these cases. It seems to work. The railroad map of today is beginning to look like the railroad map of the 1940s.

We have seen new carriers emerge. We have seen new railroad names that were the same as those that were in existence when I was a girl.

And it has been a tremendous benefit for all shippers throughout the country. And if Senator Exon were here, I would say, in particular, rural communities are seeing the opportunity for service that they did not see before the Commission pursued this paperwork speedup that we have pursued.

And as I said earlier, we now have over 10,000 miles of short line track, and 3,000 jobs that have been created as a result of the short line opportunity.

Senator PRESSLER. On the other hand, I understand that about 20 percent of the short line railroads created since the enactment of Staggers have gone bankrupt, and some others are in serious trouble.

Would it make sense to have the ICC take a look at the financial viability or technical capabilities of the acquiring entity before giving blanket approval of a sale?

Ms. GRADISON. The Commission has looked at these very closely. We had an ongoing review of the short line carriers.

The 20-percent number that you are referring to is largely carriers that were established prior to 1982 from abandoned lines.

We have found that in instances where there was a demand for service, the service was preserved or picked up or continued. And in instances where the carriers went under, it was a result of there being no traffic. And those were abnadonable lines to begin with.

Senator **Pressler**. Well, I undertand that 20 percent figure is since Staggers, at least according to testimony last week. There's apparently some difference on that.

Ms. **Gradison**. Since Staggers, since 1982, those were between 1980 and 1982, we had——

Senator **Pressler**. The 20 percent figure is since the Staggers Act is passed.

Ms. **Gradison**. Can I have Dr. Klem respond, please?

Mr. **Klem**. I have not seen the 20 percent figure. But I have looked at our study which we made of this, and a study that was mentioned in your previous hearing a week or so ago.

And in both of those, even though it was post-Staggers, essentially all the lines were formed from abandoned lines.

More recently we found some lines formed from spinoffs, the ICG spinoffs especially; but they have not gone bankrupt.

Senator **Pressler**. Well, in any event, would it make sense to have the ICC take a look at the financial viability or technical capability of the acquiring entity before giving blanket approval of a sale?

Ms. **Gradison**. No, sir. We keep a close watch on these. Where there are problems, we go ahead and do an investigation.

We are interested in maintaining the viability of these carriers, and we do it on an as-needed basis.

Senator **Pressler**. Now, what in your judgment would happen to shortline sales if labor protection were imposed on those transactions?

Ms. **Gradison**. Most of them would not go forward. Labor protection is expensive. We find that the employees of the lines before the transfer generally continue to have jobs in one form or another if they choose to.

And the $25,000 or $30,000 opportunity that was discussed last fall would pretty well provide a discontinuance of this whole new growth industry. Discontinuation of the new opportunities.

Senator **Pressler**. Thank you, Mr. Chairman. I one some more question for the record.

Let me ask a question on "revenue adequacy." There has been a great deal of emphasis placed on the fact that under the Commission's current guidelines, no railroad has ever been found to be revenue adequate. The impression we are left with is that "revenue adequacy" is the all-telling factor in determining whether relief will be granted. But the ICC has downplayed the "revenue adequacy" factor.

Could you explain to us how important a factor "revenue adequacy" is in these cases relative to other factors you consider? Specifically—and I know that no two cases are identical—but could you describe for the committee the four of five most important factors you consider in a rate reasonableness case, and the approximate relative weight in percentage terms you would assign to each vis-a-vis "revenue adequacy?"

Senator **Rockefeller**. Senator Kasten, any questions at this point?

Chairman Gradison, you have indicated that the revenue adequacy test does not make that much difference, both here and in the House, which makes even more pressure on the rate reasonableness test.

Now, there has been a lot of interest in the docket at the ICC, and the time that it takes to decide cases.

You have indicated that the guidelines are in effect; that you are resolving cases every three months. Twenty three cases, according to my calculation, would then take five years and nine months to complete.

Is my math wrong?

Ms. **Gradision**. No, they are not exclusively—we will not exclusively complete one every three months.

I am sorry to interrupt. That seems to be the past experience we have had. Hopefully, as we move through with more experience in dealing with these, the parties will have a better idea of what to file, and we will be able to process them more quickly.

Now that we have found market dominance in over ten of these cases, we are now able to proceed on the rate reasonableness aspect of it.

It is my goal that we be completed with these 24 cases before my chairmanship is over. And unless the parties do not cooperate, we should meet that goal.

Senator **Rockefeller**. In the nearly seven years since the Staggers Act, how many cases have been given final rate relief from the Interstate Commerce Commission?

Ms. **Gradison**. Well, it depends on which set of cases you are talking about.

Senator **Rockefeller**. I am talking about final rate relief.

Ms. **Gradison**. We have a listing of the section 229 cases, which was an opportunity——

Senator **Rockefeller**. Are there not only two?

Ms. **Gradison**. No, sir, no, sir.

Senator **Rockefeller**. Omaha Electric and Arkansas Power?

Ms. **Gradison**. No, sir.

Senator **Rockefeller**. Is not the proper answer, there have only been two?

Ms. **Gradison**. No, sir. We have—if you want to count in that manner, we have at least five. But for the record, I have the entire Commission major rate actions since 2/21/86, excluding the rulemakings.

Senator **Rockefeller**. Do you include San Antonio Electric.

Ms. **Gradison**. You bet we do.

Senator **Rockefeller**. San Antonio Electric was a special amendment to the Staggers Act. That has nothing to do with it.

Do you include McCarty Farms?

Ms. **Gradison**. Wait a minute. What do you mean it has nothing to do with it? Do you know how many man-hours we spent working on San Antonio Electric?

Senator **Rockefeller**. It is a special amendment. It is a special Staggers Act remedy.

Ms. **Gradison**. Senator, it is a rate case. And the Commission——

Senator **Rockefeller**. So you are saying San Antonio counts?

Ms. **Gradison**. Do you know how many hours we spent on that case? It has overlapping issues. It has precedential value, and we spent a lot of time working on it.

And in fact, their settlement request thanks the Interstate Commerce Commission for our role in it.

Senator **Rockefeller**. How many shippers——

Ms. **Gradison**. I will submit it for the record. Here it is.

Senator **Rockefeller**. All right, thank you very much.

Now in the case of—assume that the standard for grain and other noncoal commodities is to be the average rate formula, that is, a cap evolving out of this McCarty case, a cap formula, is that the ICC's position?

Ms. **Gradison**. I am sorry, I do not understand the question.

Senator **Rockefeller**. Well, the standard for grain in the McCarty case, and other noncoal commodities, you have placed in the McCarty case, a tentative decision—not a final decision, but a tentative decision—of a cap rate formula, a cap, you have put a cap on the rate.

Is that the ICC's position?

Ms. **Gradison**. In the McCarty Farms tentative decision we provided for——

Senator **Rockefeller**. Could you answer the question?

Ms. **Gradison**. I am trying.

Senator **Rockefeller**. It is a yes or no question.

Ms. **Gradison**. I am trying to answer the question.

Senator **Rockefeller**. Okay.

Ms. **Gradison**. We put together a revenue-to-variable cost ratio from which reparations would be provided.

Senator **Rockefeller**. On an average formula basis, the average of that quantity, that equaling a cap, an average cap, based upon the commodity. Your answer is yes.

Ms. **Gradison**. It is a method of establishing reasonableness; it is not a cap.

Senator **Rockefeller**. All right.

Ms. **Gradison**. I would like to allow Dr. Klem to respond to this.

Mr. **Klem**. It is only a cap in the sense that once we make the final decision, that determines the rate. But it is not any kind of an overall cap.

Each case is analyzed based on the evidence that we have in the record. There was a lot of evidence in the record in that case. And evidence that we have available to us in the Commission that is officially noticeable.

And the analysis is tailored to the specific circumstances of that case.

Senator **Rockefeller**. But you have established in this case tentatively a cap?

Mr. **Klem**. We established a revenue-to-variable cost ratio, but it is not what I think of as a cap.

Ms. **Gradison**. That was your question, and your answer is no.

Senator **Rockefeller**. Chairman Gradison, is the case final? And when would you anticipate that it would be final?

Ms. **Gradison**. The case is not final. The parties have been given the opportunity for two rounds of comments. There is a market dominance evidence that is in the record which is enough for us to move the case forward.

The decision stands unless the parties successfully refute any part of it.

Senator ROCKEFELLER. Is it possible that the ICC could in fact ultimately find against the grain shippers in the McCarty Farm case?

Ms. GRADISON. If the parties were to successfully refute a major portion of the decision, it would be possible.

It would also be possible that the parties are not successful in refuting the evidence.

Senator ROCKEFELLER. All right. In the McCarty Farm case you say that the stand alone cost test is onerous and that it is complex because it involves an analysis of, quote, "multiple origins and destinations," and quote, "diverse origins and relatively low volume shipments."

Now Chairman Gradison, that in many ways, or perhaps all ways, describes the coal fields of West Virginia, Eastern Kentucky, and Southwestern Virginia.

Could you tell me why is the situation so different in the McCarty Farm case than it is in the southern coal fields of Appalachia, since you have just described the southern coal fields of Appalachia in the McCarty case?

Ms. GRADISON. It may not be different. The purpose of coming up with the 347 sub 2 guidelines is to be able to make a rate case faster.

We still stand by the stand alone costing methodology.

It is more accurate. But it takes more time, and is therefore more expensive to prove.

I went to Montana last summer. And I came back with the opinion that we needed to come up with a way for a small shipper to be able to make a rate case that did not cost a fortune and take a lifetime to make their case.

My goal was to come up with an efficient means for small shippers to make a case. We public noticed that methodology in 347 sub 2. We provided for an extension for the parties to comment on that until the end of July.

We have used that methodology in McCarty Farms and in another case that will be coming out next week. And while, again, we believe the stand alone costing methodology is superior, particularly for the unit train coal shippers from the coal fields of West Virginia, the small coal shippers in West Virginia, do not have the time or the money to invest in producing that kind of a case.

Senator ROCKEFELLER. To summarize, Chairman Gradison, do I understand that the ICC may be moving toward the situation where there is a stand-alone cost test for large coal and that this rate cap formula which you are hesitant to admit to for small coal or all other commodities may be another test?

Ms. GRADISON. No, sir. We do not have a rate cap formula. I do not know who briefed you for this, but that is incorrect.

Senator ROCKEFELLER. You have established a 244 percent——

Ms. GRADISON. When you came in this morning you said that you were appalled, but I do not think you have been watching our actions in the last 18 months because if you had been watching our actions you would see the revisions that we have made in revenue adequacy, you would see the revisions that we made in the RCAF formula, and you would see that the rate cases that we have processed, my rate docket is half of what it was a year ago.

Where did those cases go? They were settled by the parties, and they were settled by the parties because we provided the guidelines for them to settle. They were settled by the parties because in the instances where we have provided for reparations, the rail carriers recognize that our coal rate guidelines put them at risk.

I just cannot believe that after 18 months you are still singing the same song that you were a year ago. You are not informed of our current docket, and it is irresponsible for you to propose changes in legislation when we have been doing the job that needs to be done.

I am in favor of deregulation, but I am not in favor of rail carriers taking advantage of captive shippers. There is a balance, but the balance does not have to be a cumbersome paperwork overload to overload 85 percent of the rail shippers as opposed to the 15 that are captive. The 15 that are captive have to bear the burden of making their case, but the 85 percent should not pay those costs.

If we want to have a continued rail industry for that 85 percent of competitive shippers to help support what the 15 percent need, what your coal shippers need, then we have to come up with a reasonable test, and the Commission has done it.

You are not recognizing what we have done, and I think it is unfair.

Senator ROCKEFELLER. What I think is unfair and what I am recognizing is that since the passage of the Staggers Act, there have been a total of two shippers who have received rate rail relief from the Interstate Commerce Commission. That is a period of seven years, which is an absolute outrage. Any student, any observor, any analysis of your recoord makes that very, very clear.

Are there any more questions from the panel?

Ms. GRADISON. I have something else I would like to say.

Senator ROCKEFELLER. Please go ahead.

Ms. GRADISON. Staggers provided the opportunity for some 850 section 229 rate disputes to be filed. Proctor & Gamble filed 130 rates disputes, 90 of which were settled amicably to Proctor & Gamble's satisfaction.

That was rate relief. Thirty of those were dismissed because there was no traffic left to dispute. Excuse me, it was 120. That is an example of how the change in the statute has worked.

I had the opportunity to visit some major shippers to see how they transport their goods today because I knew the industry rather well before 1980. They are using the technology that is available that they could not use when tariffs were the only form of determining what a rate could or should be.

They are able today to negotiate a price, transport the goods, and pay for it in one computer transaction. That is a result of technology, and they can use that, but they could not use it without Staggers.

Senator ROCKEFELLER. Thank you, Chairman Gradison, very much, and thank all of you other gentlemen also for your presence here today.

[The statement and question and answers follow:]

STATEMENT OF HON. HEATHER J. GRADISON, CHAIRMAN

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

Thank you for this opportunity to present the views of the Commission concerning the implementation and effects of the Staggers Rail Act of 1980. The specified goals of the Act are: (1) to assist the railroads of the Nation in rehabilitating the rail system in order to meet the demands of interstate commerce and the national defense; (2) to reform Federal regulatory policy so as to preserve a safe, adequate, economical, efficient, and financially stable rail system; (3) to assist the rail system to remain viable in the private sector of the economy; (4) to provide a regulatory process that balances the needs of carriers, shippers, and the public; and (5) to assist in the rehabilitation and financing of the rail system.[1]

These goals stress the rehabilitation of the rail system--reflecting Congress' concern that a continuation of the status quo ante would have resulted in the loss of a viable private-sector rail system. Equally important, the Act sought reform of regulation, both as to process and substance. A balanced climate was the goal. Railroads were to have the flexibility and incentive to perform efficiently, but the Commission was to insure that captive shippers were not abused by the new freedom. Measured by these purposes, there is little question that the Staggers Act is working successfully.

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[1] Pub. L. No. 96-448, sec. 3, 94 Stat. 1897.

Railroad health has improved since Staggers, but profit still remains modest. This can be seen by a comparison of earnings with other industrial sectors. In 1986 rail transportation ranked 34th out of 40 major industrial sectors.[2] Over the last six years, the rails have ranked between 25th and 34th. While uninspiring, the performance exceeds that of the three years prior to Staggers when the rankings were between 33rd and 37th of what were then 39 categories. This marginal improvement has been sufficient to promote investment and innovation. Remarkably, the improvement has come from greater efficiency, not from higher prices -- the real cost of rail transportation is lower on average today than in 1980. (See Attachment B.)

What dispute there is over Staggers centers on the goal of a balanced regulatory process. The Commission has energetically addressed this issue in the 16 months that have passed since last presenting testimony to this Subcommittee. We believe that our efforts have been successful, and that a balanced climate exists. Railroads have been given the flexibility necessary to succeed, while captive shippers are being protected from monopoly abuse.

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[2] Business Week, Annual "Corporate Scoreboard" various issues. Summary appended as Attachment A. Railroad earnings were adjusted to exclude large special charges to record major restructuring of operations (substantial reductions in personnel and writedowns of track and equipment). Otherwise, the railroad industry in 1986 would have ranked 38th out of the 40 major industrial sectors. If we were able to make similar adjustments to the earnings data of the other industrial sectors (pertinent data about their special restructuring charges were not available), the railroad industry ranking might be slightly higher (more unfavorable) than 34th in 1986.

EFFECT OF THE STAGGERS ACT ON INDUSTRY PERFORMANCE

The differences in performance before and after Staggers are, in some ways, so striking that a comparison of a few years on either side of enactment can be eye-opening. Discussed below are a series of pertinent measures of this performance. The data indicate that profitability is up, but prices are down, because efficiency is up. This data is so critical to an understanding of the post-Staggers Act experience that a line-by-line review will be beneficial.

Line 1: Operating Income in 1985 dollars[3] ($000,000)

	77	78	79	80	81	82	83	84	85
(1)	568	659	1187	1706	1585	800	1963	2592	1748

Line 1 indicates that there has been some improvement in operating income. These numbers are adjusted for inflation but the years since 1983 reflect different assumptions regarding the accounting for track investment.4 The accounting change tends to overstate the after-Staggers improvement. But improvement is there. Moreover, the industry weathered the deep recession of the early part of this decade without negative numbers, and without further bankruptcies.5

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[3] Source: Table 4 -- Class I Line-Haul Railroads, Condensed Income Statement, Financial Ratios and Employee Data, Interstate Commerce Commission Annual Reports.

Line 2: Rail Percent Return on Investment6
Line 3: Rail Profitability Compared to Other Industry7

	77	78	79	80	81	82	83	84	85
(2)	Neg	1.45	2.70	3.85	3.78	2.00	4.25	5.57	3.76
(3)	Neg	.10	.33	.39	.84	.65	.60	.75	.61

Line 2 confirms the improvement in earnings, but Line 3 demonstrates that -- even as improved by Staggers -- railroads are a low-earning industrial sector. During the late 1970's a period when interests rates were at an all-time high for this country, the railroads were earning rates of return near two percent. These figures are not aberrational, the entire decade of the 1970's looks about the same. For the post Staggers period, there is a marked improvement, almost doubling the

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[4] In 1983, the Commission required a change from a unique method of accounting for the expenditures on track structure to the use of the standard depreciation accounting. This change tended to boost the earnings by reducing the immediate annual track expense item.

[5] While not reflected in the Line 1 data, 1986 rail earnings, adjusted for inflation, were $493 million. The drop in earnings from prior years resulted from the large writedowns taken in 1986. Earnings before writedowns were $1815 million.

[6] *Supra* note 3.

[7] *Business Week*, "Corporate Scoreboard," various years.

average return to something above four percent.[8] But as the figures in Line 3 demonstrate, rail earnings never became more than a fractional part of the earnings for business generally.

Line 4: Average train miles per hour[9]
Line 5: Ton-miles per train hour (000)[9]
Line 6: Ton-miles per yard hour (000)[9]

	77	78	79	80	81	82	83	84	85
(4)	19.8	19.3	17.2	18.2	19.0	21.4	20.3	21.4	21.9
(5)	40.1	39.2	36.0	40.4	43.1	50.2	49.4	54.5	56.3
(6)	31.4	32.4	34.9	39.6	41.4	47.9	57.0	63.9	65.9

Earnings improvement, coupled with favorable tax treatment, has resulted in improvement in service. Slow orders, which restricted speed on 47,000 miles of track in the years just prior to Staggers[10] have been reduced markedly, allowing average speed (Line 4) to increase from 17 miles per hour in 1979 to 22 miles per hour in 1985. This is almost a 30 percent increase. New investment and more flexible marketing rules have also produced heavier, more efficient trains. Revenue ton-miles per train hour (Line 5) have increased from 36 million in 1979 to 56 million in 1985 which is an increase of over 50 percent. Similarly, revenue ton-miles per yard hour (Line 6) more than doubled. Heavier trains are traveling faster and moving through the yards more efficiently.

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[8] Coal stockpiling in anticipation of a possible mine workers strike dramatically increased earnings in the late quarters of 1984. Reductions from this stockpile correspondingly reduced earnings in 1985. Consequently, the rates of return for those two years might reasonably be leveled through averaging.

[9] 1977-1978, "Operating Statistics Annual," Statement 100; 1979-1985, Railroad Annual Reports, (R-1), Interstate Commerce Commission.

[10] S. Rep. No. 470, 96th Cong., 1st Sess., 3 (1979)

Lines 7 and 8: Rail Prices -- Yield per Ton (1985 $)[11]
Line 7: All Commodities
Line 8: Coal

	75	76	77	78	79	80	81	82	83	84	85
(7)	20.7	21.9	22.4	22.5	22.1	22.8	23.6	22.5	21.5	20.5	20.2
(8)	9.9	10.3	10.7	11.2	11.5	12.3	13.6	13.6	13.0	12.6	12.2

The most gratifying part of the revival initiated by Staggers is that improved profitability has not come at the expense of shippers. To the contrary, as a result of new competition under Staggers, shippers are better served today, and prices have generally fallen. Line 7 is an aggregate measure of rail price for all commodities. The numbers there translate into a 14% decline from the peak in 1981. Actually, the decline shown here is understated. The measure of revenue per ton was deliberately used in an effort to be conservative. In recent years the average distance shipped on Class I railroads has increased almost 8%. Rails tons are being shipped more miles for less. Using only the tons measure, as opposed to the ton-mile measure, thus understates the price declines somewhat.

As the graphs appended as Attachment B indicate, this pattern of decline from the peaks following passage of Staggers is quite consistent for most commodities. It is also true for both the eastern and western halves of the country.[12] For some commodities, coal amongst them, the benefits took longer to occur. However, the record on coal rates is also quite positive and improving. Nationwide, coal yields peaked in 1981/82, and have declined steadily thereafter. Overall, coal today is moving at lower inflation-adjusted yields than it did in 1980. The picture in the East is brighter, in the West rates did not turn down until 1984. As is discussed in detail in the sections below, the Commission believes that this downturn is directly related to Commission entry and maximum rate policies. We feel confident that prices will continue to decline until fully efficient prices have been settled upon.

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[11] ICC Data: Form R-1 and Form QCS.

The discussion just concluded depicts improved profits, better service, and prices. Naturally, the results vary from firm to firm, from shipper to shipper. But on average, and for the most part, the picture of improved vitality, lower prices, better service, all stemming from less regulation, is accurate. It is, however, correct to ask, what about the exception, what of the captive shipper who is caught in the transition from one set of Federal rules to the next? In the discussion below, we address the active role the Commission has taken to insure that the exception is fairly treated.

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[12] In addition to the nationwide picture, revenue per ton in the East and West were examined separately.

ADMINISTRATIVE IMPLEMENTATION
1986-1987

In testimony presented to this Subcommittee last February, the Commission presented its view that the Staggers Act was functioning well and that the Act need not be amended. This year I would like to concentrate on recent developments which demonstrate that the Commission is using the Staggers Act to further the National Transportation Policy. These have been numerous, significant, and many are directly related to the concerns of sponsors of new legislation before your Subcommittee. Major actions have been taken regarding rail rates, revenue adequacy, competitive access and other important subjects.

Rate Regulation

The Staggers Act and the 4R Act were intended to reduce the regulation of rail rates. The Commission was charged with regulating only where there was an absence of effective competition. In addition, as an alternative to collective ratemaking, the Staggers Act introduced the concept of index-based rate increases. Thus, the Rail Cost Adjustment Factor was proposed as a method for recovering inflationary increases. Implementation of these various rate provisions of the Staggers Act has been criticized, for the most part, as having been overly sympathetic to the revenue needs of the carriers. In the past eighteen months, the Commission has taken several significant steps that address these criticisms.

Rail Cost Adjustment Factor

Section 203 of the Staggers Act created the Index of Railroad Costs and the Rail Cost Adjustment Factor (RCAF), which are compiled and published quarterly. An increase in a rail rate cannot be found unreasonable if it occurs in concert with a commensurate rise in the Adjustment Factor. Section 203 is silent as to the impact of decreases in the index. It is generally believed that this silence is a result of the prolonged period of rapid inflation preceding enactment; price decreases were not anticipated. However, prices for rail inputs have fallen occasionally, and, in the first quarter of 1986, fuel prices fell substantially, causing a decline in the index. The decline brought a renewed call from shipper groups for rolling RCAF rates, that is, rates that would go up and down with changes in the index.

In Ex Parte 290 (Sub-No. 2), Railroad Cost Recovery Procedures, the Commission proposed (May 1, 1986) to amend its existing rules to require that when the RCAF declines in a given quarter, rail rates established under RCAF procedures should also decline. The Commission also proposed to adopt a mechanism to offset forecasting errors made in earlier periods. Final rules were adopted (Oct. 17, 1986) that: (1) required a 1.1% roll back in existing RCAF rates;13 (2) created a "banking" methodology that defers any future increases until such time as past discrepancies are eliminated; (3) provides for "rolling" rates once the "banked" shipper credits are exhausted; and (4) adopts an error-correction methodology. The completion of this rulemaking is a major step introducing balance into the index procedures. For the past two quarters, while the index has crept upward, no rate increases have been allowed under Rail Cost Adjustment procedures because of shipper credits in the "bank."

Maximum Rates

The Commission decided several important maximum rates cases, the most important of which involved the implementation of coal rate policy. In Omaha Public Power District v. Burlington Northern Railroad, (Nov. 20, 1986) the Commission issued its first decision implementing its Coal Rates Guidelines.14 The

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13 Rate reductions ordered in the Ex Parte 290 (Sub-No. 2) proceeding do not foreclose rail carriers from taking offsetting independent increases. Independent action is encouraged by Staggers, and, on rates below the jurisdictional threshold, carrier flexibility is not subject to regulation. Where rates above that threshold are increased by independent action, normal procedures for protest apply. Our analysis indicates that there have been independent tariffs filed seeking recovery of the 1.1% reduction. These have not been filed by all carriers or for all commodities, and they have contained many exceptions. No shipper protests were filed against any of the increases observed during the study period.

14 Notice of Final Guidelines, 1 I.C.C.2d 520 (1985).

decision found that a once captive utility[15] had been overcharged during a two and one-half year period. The Commission ordered reparations with interest. In a second application of the Guidelines, Arkansas Power and Light v. Burlington Northern Railroad, (May 13, 1987) the Commission again found that certain, although not all, of the contested coal rates exceeded maximum reasonable levels. Reparations with interest were awarded. In both of these cases, complainants successfully employed the Commission's stand-alone costing methodology in demonstrating the excessive nature of past charges.

In another important coal rate controversy, the Commission awarded reparations to the City of San Antonio, Texas. (16) Section 203(c) of the Staggers Act set a special rate level of 162% of variable cost as a cap for certain coal movements. This cap was found to apply to coal that had been shipped to San Antonio from the Powder River Basin. The Commission considered evidence as to whether the actual rate had exceeded the statutory cap. An excess was found and reparations were ordered. The case set important precedent on variable cost issues, as the Commission accepted shipper innovations to traditional costing, particularly on the estimation of maintenance of way costs.

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[15] Commission action in Finance Docket No. 29975 introduced new competition to the Powder River Basin coal mine serving the Omaha power plant. Consequently, the prescription of future rates became unnecessary. A competitively bid contract now covers this service.

[16] San Antonio, Texas v. Burlington Northern Railroad Co., served April 11, 1986.

These newly adopted methodologies were critical to the outcome of the case, and, in important features, were followed in the Omaha Public Power proceeding as well.

The award of reparations under Staggers section 203(c) resolved only a part of the controversy between the City and the two roads serving it, the Burlington Northern and the Southern Pacific. The remainder of the case was to be governed by the Commission's Coal Rate Guidelines. After issuance of the Omaha Public Power decision, the rest of the San Antonio controversy was settled between the parties. In the completed phase of the San Antonio dispute, reparations of $40,065,267 plus interest were ordered. In the full settlement, the defendant railroads agreed to pay $111,500,000 to the City. The Commission believes that difference between the reparations figure and the final settlement reflects an awareness by the rail carriers that Coal Rate Guidelines represent an effective cap on excessive coal rates, and that, consequently, they were at risk in continued litigation.[17]

Reparations were also ordered in a fourth group of cases, Commonwealth Edison Co. v. Aberdeen & Rockfish Railroad Co.[18] These cases were brought by numerous utility companies and the Departments of Energy and Defense, and the complaints were made against all railroads involved in the transportation of nuclear waste materials. The Commission found that the rail carriers were engaged in an unreasonable practice, in that they sought to avoid their common carrier obligation to carry spent nuclear fuels through the practice of charging "special train rates" at levels far above the actual cost of service. In addition to reparations, a rate level for future movements was prescribed.

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[17] In its petition to dismiss the remainder of the suit, San Antonio expressed its "appreciation for the time, effort, patience, and energy which the Commission has dedicated to its case."

[18] Docket No. 37891S, served August 8, 1986.

Maximum Rate Case Management

During the 1986-87 period, the Commission's maximum rate caseload was reduced by more than half. As of February 21, 1986, the date of the 1986 hearings, the maximum rate docket stood at 50 proceedings, embracing 80 individual complaints. As of June 1st of this year, there are 23 active proceedings, embracing a total of 31 cases. Only three new cases have been filed since the beginning of 1986, and of these, only one remains pending.

Despite this reduction in numbers, the Commission continues to allocate top priority to the movement of these cases. The Commission issued 10 final market dominance determinations in the past 15 months, finding that market dominance existed in nine of the ten proceedings.[19] These cases can now move to a determination of rate reasonableness.

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[19] These figures reflect activity through May 1, 1987. Additional market dominance decisions have been issued in McCarty Farms, infra, and one coal case.

As in the past, the preponderance of cases are not closed by order of the Commission, but by settlement among the parties. The gratifying record of settlements over the recent period is attributed to a number of factors. The decisions in the San Antonio and Omaha proceedings gave litigants solid information as to how the Commission viewed important issues surrounding variable costs and the application of the final Coal Rates Guidelines. The exact impact of these decisions on the settlement of pending cases is unknown, but the fact of impact is almost certain. In the wake of the San Antonio and Omaha decisions, the Burlington Northern settled with complainants in other long-standing Powder River disputes, in addition to the settlement with the City of San Antonio mentioned above.

A second factor in producing settlements has been the use of docket management conferences. Cases that have been sitting idle "pending negotiations" have been accelerated through conferences before the agency's Chief Administrative Law Judge in which a "fish or cut bait" attitude has been adopted. Parties have been strongly encouraged to either negotiate seriously or begin (resume) the process of "record-building" so that the merits may be presented for decision. This process has worked, if not by provoking settlement, then at minimum by producing movement toward closed records for decision.

Now that standards appear at hand for non-coal and small shipper cases, docket management conferences may produce additional gains. The Commission is already applying (where circumstances permit) the standards under development in Ex Parte 347 (Sub-No. 2) to non-coal cases now pending. The first such application is in the McCarty Farms et al v. Burlington Northern cases.[20] The Burlington Northern was found to have market dominance over the movement of Montana grain and, using one of the newly proposed standards, rate levels were tentatively found to be excessive. Similar use of these new procedures will permit decisions to be rendered in several long-standing disputes, while minimizing the "record-building" expense to the parties.

Revenue Adequacy

In the past year the Commission reconsidered its revenue adequacy standards from the ground up, made substantial revisions to those standards, and used the new standards[21] in making the current revenue adequacy determinations. Even with the revised standards, no Class I carrier was found revenue adequate. This fact has led to renewed criticism of the Commission's standards.

In Ex Parte 393 (Sub-No. 1), Standards for Railroad Revenue Adequacy, the Commission announced, in June 1986, a complete review of all revenue adequacy standards. Specifically targeted for reassessment were the issues of: (1) depreciation accounting for track structures; (2) elimination of the impact of deferred taxes; and (3) the use of embedded debt in the cost of capital calculation. This review was completed and a revision of the standards was published in December.[22] The revised standards reaffirm the reliance on a "return on investment" approach. This is the normal public utility approach to judging a firm's earnings by comparison of its rate of return to the cost of buying capital in the marketplace. This methodology has two distinct undertakings: (1) the estimation of the firm's present earnings, and (2) the estimation of the true cost of capital for the industry.

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[20] Docket No. 37809 et al., served May 27, 1987.

[21] Changes made to effect consolidated reporting for single-system carriers and to adjust the accounting for interest and income taxes were not reflected, because data under the new approach was not yet available. However, these factors are relatively minor in significance compared to the deferred tax and depreciation changes which were implemented, and would not have changed the outcome of the 1985 determinations for any carrier.

As to the first half of the process, the Commission's revised standards are fully in line with traditional public utility accounting. The removal of deferred taxes from the investment base, a consistent point of criticism regarding the earlier standard, affects significantly the estimated returns of the Class I rail carriers. Likewise, the change to standard depreciation accounting also had a significant impact on return on investment. The table appended as Attachment C shows the impact of these adjustments on the rates of return of the Class I carriers. Recent analyses done by the General Accounting Office[23] and the Railroad Accounting Principles Board[24] support the Commission's revised standards.

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[22] Ex Parte No. 393 (Sub-No. 1), Standards for Railroad Revenue Adequacy, served December 31, 1986.

[23] United States General Accounting Office, Railroad Revenues: Analysis of Alternative Methods to Measure Revenue Adequacy, October 1986.

There remains dispute over estimation of a target rate of return. The issue centers on the calculation of the cost of debt. In its June 1986 notice, the Commission indicated that it was considering the use of embedded debt -- that is, the cost of debt already on the books of the rail carriers -- in calculating the cost of capital. (The remaining component in this calculation is the cost of equity capital, which is done consistent with public utility practice.) The alternative to embedded debt is the cost of current debt, an alternative which the Commission has used since shortly after Staggers enactment. After reconsidering the matter, a majority of the Commission decided that the standard should continue to employ the current cost of debt for the estimation of the target rate of return.

There are credible arguments on both sides of the cost of debt controversy. On the one hand, it can be said that a return to a regulated firm in excess of its actual cost of debt is, almost by definition, above the known expenses of the firm. Under this view, allowing current costs, if they are higher than embedded costs, is much like allowing a markup on real wage expense, or fuel. Consequently, state utility regulators use embedded debt costs. On the other hand, the rail market is primarily competitive. Unlike state electric utility commissions, the ICC cannot, and does not attempt to, insure that each of the regulated firms is fully profitable. By statute, our rules must permit the opportunity for carriers to attract the capital necessary for reinvestment in an efficient system. The use of current debt costs helps to provide this opportunity. Moreover, the railroads receive no guarantee that the cost of embedded debt will always exceed the cost of current debt. The differential has dropped in recent years with the decline in interest rates.

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[24] The Railroad Accounting Principles Board was created by Section 302 of the Staggers Rail Act. Its membership is appointed by the Comptroller General, and it is assigned the task of establishing principles for governing the determination of economically accurate railroad costs for use in regulatory proceedings by the ICC. The Board's Exposure Draft, published February 20, 1987, fully affirms the use of a return on investment standard as calculated under the revised Ex Parte No. 393 (Sub-No. 1) standards.

Since the Commission's maximum rate standards do not permit the fact of revenue inadequacy to justify an excessive rate,[25] captive shippers are not put at risk by use of current debt costs. The Rail Accounting Principles Board agrees with the Commission's reliance on current cost, and the General Accounting Office found the arguments on both sides respectable and offered no preference.

Whatever one thinks about the theoretical aspects of this controversy, it is important to keep in mind that it has little practical consequence. Because debt is only 28% of the investment base, no defensible cost of debt would have made even one railroad revenue adequate. The Commission's cost of equity, a far more important number, is in the middle of the range used by other commissions. Consequently, we believe the practical consequences of any change in methodology would be quite narrow.

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[25] In each of the reparations cases cited in the "Rate Regulation" section above, the rail carriers against which reparations were awarded were revenue inadequate. In the Omaha Public Power case, the Burlington Northern argued explicitly that its status as a revenue inadequate carrier should be regarded as a shield against damage awards. The Commission rejected the argument without hesitation.

The Commission has also given extended consideration to the proper calculation of equity capital. In Ex Parte No. 464, Railroad Cost of Capital - 1985, public participants were asked to provide comment on alternatives to the "Discounted Cash Flow" (DCF) methodology presently employed. While DCF is the most widely used methodology among state regulatory commissions, the Commission was concerned that aspects of the methodology were not performing accurately for the rail sector. Comments indicated that other widely used approaches produced higher equity costs, with less apparent justification than the existing methodology. Since the Commission's current standard was not shown unreasonable, Commission staff undertook to compare the target return on equity generated for rail carriers by the current methodology against the targets set by state utility commissions. The results showed the ICC figure (14.7%) to be almost precisely identical to the average for the state commissions, which, given the additional risk factor generally ascribed to rail transportation, indicates that the ICC approach is well supported.[26] While we continue to employ the existing standard, we have again asked for comment on improving the methodology in Ex Parte No. 466, Railroad Cost of Capital - 1986.

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[26] See Attachment D.

Finally, in order to speed the cost of capital determination, we have proposed accelerated time tables for the submission of data and comment in future proceedings. Ex Parte No. 466 (Sub-No. 1), Railroad Cost of Capital - Proposed Expedited Procedures.[27]

Competitive Access

The Staggers Rail Act encourages reliance on competitive entry. Competition among railroads, or at least the realistic threat of competition, was seen as an important safeguard against inadequate service or unreasonable price.[28] To foster new competition, Congress enacted changes to the provision governing the construction of new lines, and provided, for the first time, explicit power to require mandatory switching.[29] Intra-rail competition is also substantially affected by the use of through routes and joint rates. The Commission has been active in all these areas in the 1986-87 period.

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[27] Served April 27, 1987.

[28] H. Rep. No. 1035, 96th Cong., 2d Sess., 66 (1980).

[29] Mandatory switching refers to the movement of cars within a terminal area by one carrier for the benefit of a second carrier. Switching differs from joint line service in that the switch is typically performed for a flat fee, and is not directly related to rates charged, or the origins or destinations of the switched cars. The Staggers Act (Section 223) uses the term "reciprocal switching," suggesting that any obligations imposed by the Commission would run to both (or all) carriers involved in a particular controversy. In practice, the requests received by the Commission have not involved reciprocal obligations.

New Construction

The Staggers Act amended the new construction provision of the Interstate Commerce Act to reduce the burden that a willing entrant had to meet before an application for new construction could be granted.[30] In Finance Docket No. 30700, Chicago and North Western -- Construction and Operation -- In Campbell County, WY,[31] the Commission addressed the application of the new Staggers Act standard for the second time in the context of Powder River Basin coal transportation. New construction was approved again, resulting in additional competition for substantial coal reserves held by Mobil, Exxon and AMAX.

The maturing of a second system in the Powder River Basin has born out the expectation of Staggers regarding the benefits to be derived from new competition. Press accounts of competitively bid contracts for Powder River coal transportation indicate savings to consumers between $1 and $7 per ton. (Present annual production from the region is approximately 250 million tons.) From the ICC's perspective, we have also seen a rapid evaporation of Powder River caseload, as the impact of the

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[30] The old standard stated that authority had to be required or shown to enhance the public convenience and necessity. Staggers softened this standard, and additionally gave new entrants eased entry over the lines of other rail carriers. Pub. L. No. 96-448, sec. 221, 94 Stat. 1928.

[31] Served January 15, 1986.

Commission's Omaha Public Power decision, coupled with the need for competitive bidding, has produced a number of settlements, including the settlement with the City of San Antonio mentioned above.

The Commission approved new construction applications in other proceedings during 1986-87.[32] Experience with these and similar applications in the past several years indicates that a less costly, less uncertain administrative processing ought to be made available. While the benefits of competition through new construction are readily apparent, applicants have been put in a defensive posture by the existing rules governing filing. They are often forced to respond to extensive and repetitive opposition. To eliviate this problem, the Commission has issued an advance notice of proposed rulemaking to consider whether new construction applications can be handled under efficient procedures which will distribute more properly the burden in these proceedings, and insure that they are completed quickly.[33]

Switching and Trackage Rights

Apart from new construction, competitive entry can be achieved through mandatory switching and trackage rights. Section

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[32] See Finance Docket No. 28272, Star Lake Railroad Co.--Rail Construction and Operation in McKinley County, New Mexico, (access to coal reserves in San Juan Basin); Finance Docket 30186, Tongue River Railroad Company - Rail Construction and Operation in Custer, Powder River and Rosebud Counties, Montana, served May 9, 1986, (access to coal in Tongue River Valley).

[33] Ex Parte No 392 (Sub-No. 3) Class Exemption for Rail Construction Under 49 U.S.C. 10901, served May 29, 1987.

223 of the Staggers Act enacted a new provisions that permits the Commission to order one carrier to pick up or deliver within terminal areas the cars of a second carrier for a fee, where the switching is practicable and in the public interest, or where the switching is necessary to provide competitive rail service.34 The proper interpretation of this section has been the subject of much debate. Legislative history gives only scant guidance, speaking to the need to encourage switching to promote competition,35 but suggesting that its application is most clear where existing service is inadequate.36 The Administration bill introduced in 1979 would have made switching mandatory in all standard metropolitan areas. This was rejected by both Chambers in favor of a discretionary approach. While a few critics press for an aggressive program that would use switching to introduce widespread changes in the rail service, the Commission has chosen to interpret the section along the lines presented to it by shipper and rail groups in Ex Parte No. 445 (Sub-No 1), Intramodal Rail Competition. These rules, adopted in 1985, provide that switching will be ordered where needed to remedy competitive abuse or its threat.37

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34 Pub. L. No. 96-448, sec. 223, 94 Stat 1929.

35 H. Rep. No. 1035, 96th Cong., 2d Sess., 67 (1980).

36 S. Rep. No. 470, 96th Cong., 1st Sess., 42 (1979).

37 While strictly speaking the Intramodal Rail Competition rules do not govern trackage rights applications, many of the same considerations can apply. See No. 39021, Midtec Paper Corporation v. Chicago and North Western Transportation Co., at 6, served December 15, 1986.

Economically speaking, the preference for a discretionary approach based on a showing of competitive need arises from the uncertain maintenance and investment consequences of forced access into one firm's plant to the benefit of its competitors, an issue which raises knotty problems regarding compensation. Legally speaking, the Commission's rules are more consistent with the approach taken in Staggers, that is, entry keyed to competitive need, whereas our critics appear to seek the type of broad and automatic application offered by the Administration in 1979, but rejected by Congress in 1980. In a decision upholding the Commission's Intramodal Rail Competition rules, the court, reviewing pertinent legislative history, indicated that it saw "not the slightest indication to mandate a radical restructuring of the railroad regulatory scheme."[38]

Requests for use of the new switching provision have been infrequent. In the six years since passage, we have received fourteen petitions or applications directly requesting relief under the section. Three of these are pending, and four were dismissed at the complainant's request after settlement. Of the remaining seven, the Commission denied switching in four cases,[39] granted it in two, and, in the last, the Commission suspended a tariff restricting the use of switching, which was then withdrawn.

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[38] Baltimore Gas and Electric Company v. United States and Interstate Commerce Commission, Nos. 85-1761 and 85-1845, slip op. at 15, (D.C. Cir. Apr. 21, 1987).

[39] Two denials have been appealed. In Central States Enterprises v. Seaboard Coast Line Railroad, No 38891, served May 15, 1984, the Commission's finding that the request was not related to competition was affirmed. Central States Enterprises, Inc. v. I.C.C., 780 F.2d 664 (7th Cir. 1985). The second case,

In the first switching case given explicit consideration under the new Intramodal Rail Competition rules, the Commission found no basis in the record on which to grant relief. In this case a paper company and the Soo Line Railroad sought forced switching and trackage rights on the Chicago and North Western system. The Commission's decision, entitled Midtec Paper Corporation v. Chicago and North Western,[40] has been frequently mischaracterized.

Under the Intramodal rules, the focus of concern is on competitive problems. When Midtec was first considered, which was prior to adoption of Intramodal,[41] the Commission concluded that reciprocal switching could not be ordered in the absence of a showing of market dominance. This aspect of the decision was critized sharply. Upon reconsideration in the context of the Intramodal rulemaking, the Commission abandoned this position, and the earlier holding was explicitly overruled in the second Midtec decision. The Commission indicated it would look directly at the issue of competitive misbehavior. Further, it made clear that the Commission's review was not limited to pure antitrust claims, but that we would also consider evidence of unreasonable

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Midtec, remains pending. See note next following and accompanying text.

[40] No. 39021, served December 15, 1986.

[41] Midtec Paper Corporation v. CNW, 1 I.C.C.2d 362 (1985).

rates or poor service -- matters which would not themselves be considered as sufficient to support an antitrust claim. Despite the availability of this flexible format for the demonstration of competitive harm, the record in Midtec did not disclose abuse. Consequently, relief was denied. Had it been granted here, the precedent established would logically have provided forced switching almost automatically in one-carrier markets. The Commission declined to do, in the context of an isolated-adjudication, what Congress had declined in 1980, and what had been rejected by a majority of the shippers in the negotiations surrounding the Intramodal agreement.

In the 1986-87 period, there have been significant actions regarding trackage rights outside of the context of the Intramodal rules. In one instance, over the opposition of the Chicago and North Western and the Grand Trunk, the Soo Line was given important new access to the Detroit-Chicago and Chicago-Eastern Canada markets.[42] In another, the Commission granted trackage rights to the Denver and Rio Grande and the MKT, in order to ensure that competitive access conditions prescribed in an earlier merger would become effective.[43]

Joint Rates

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[42] Finance Docket No. 30703, Soo Line Railroad Company--Joint Use of Lines--Chesapeake and Ohio Railway Company, served September 10, 1986.

[43] Finance Docket No. 30759, Denver and Rio Grande Western Railroad Company and Missouri-Kansas-Texas Railroad Company v. St. Louis Southwestern Railway Co., served January 9, 1987.

In enacting the Staggers Act, Congress recognized that the existing joint rate system was a serious problem for the rail system.[44] While the new law provided for some limited relief, the Conferees believed that the Commission already had authority to address the roots of the problem.[45] As it has turned out, much of the controversy surrounding joint rates has arisen under the pre-existing provisions of the Interstate Commerce Act. Several carriers moved aggressively to eliminate the unprofitable divisions and uneconomic routings that Congress had recognized as problems. (See note 44 above.) The Commission permitted many of these actions to go forward. Thus, joint rate cancellations in the years immediately following Staggers created substantial controversy.

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[44] The Conference Report states:

> Two of the major problems caused by the existing joint rate system are too low-divisions and a proliferation of uneconomic routes protected by the archaic "commercial closing" doctrine.

H. Rep. 1430, supra, at 111.

[45] In referring to the new surcharge provisions for joint rates, the Conference Report states:

> These provisions ... in no way imply an intent on the part of Congress that a carrier's existing rights under the Act to secure improved earnings over specific routes should be limited. The Conferees recognize that a carrier cannot remain healthy only earning revenues at (the surcharge) levels, but believe ...existing remedies, assuming the Commission chooses to administer them in order to realize the revenue adequacy goals of the Act, should be adequate to remedy other joint route and division problems.

H. Rep. 1430, supra, at 112.

This controversy was largely responsible for the adoption in 1985 of the Ex Parte No. 445 (Sub-No. 1) Intramodal Rail Competition rules noted above. These rules provide greater notice to shippers than had been the case earlier, and they provide an opportunity for a negotiated agreement before litigation is commenced. The rules also provide that the Commission will prevent the cancellation of a joint rate, or prescribe a new one, where necessary to remedy or prevent an act that is contrary to the competition policies of the National Transportation Policy or is otherwise anticompetitive. Ex Parte No. 445 (Sub-No 1) was recently affirmed in the courts.[46]

To date, the joint rate experience with the new rules has been limited, which may in itself be a good sign.[47] The cancellation of joint rates has been protested only on three occasions under the new rules. The liberal suspension standards incorporated in the new rules have led to suspensions in each of the protested cancellations. In one case, the Commission, over the objection of a Class I carrier, permitted cancellation by a Class III carrier to take place, finding that the cancellation promoted efficiency and was not anticompetitive.[48] In the other two instances, the cancellation tariffs were withdrawn after the suspensions were affirmed by the Commission.[49]

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[46] See note 38, above.

[47] Since the rules provide for 45 days advance notice of joint rate cancellations, and also provide that a carrier must offer a justification and negotiate with aggrieved parties, there may well be occasions in which the rules will have their desired effect -- the resolution of disputes -- but the Commission will not be a party to the resolution.

In addition to the Ex Parte No. 445 (Sub-No. 1) proceedings, the Commission also decided a very significant case involving broad joint rate cancellations effected by Conrail in 1981. These cancellations were permitted by the Commission in 1982,[50] in a case which gave rise to much of the controversy noted above. The Commission's original decision was overturned on appeal, the court finding insufficient evidentiary justification of the cancellations.[51] On remand, the Commission reopened the case for new evidence, and, after considering the updated record, reversed its prior holding and found the cancellations unsupported by the evidence. Conrail was ordered to renegotiate the cancelled rates, with the burden placed on Conrail in any subsequent disputes which could not be negotiated.[52]

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[48] I & S No. 9266, Cancellation of Joint Rates at Bureau, Il, IIRR, served December 2, 1986.

[49] I & S No. 9267, Cancellation of Single-Factor Through Joint Rates on Coal, CNW; I & S No. 9268, Cancellation of Joint Rate on Transit at Gonzales, TX, SP.

[50] Changes in Routing Provisions - Conrail - July, 1981, 365 I.C.C. 753 (1982).

[51] Chesapeake and Ohio Ry. Co. v. United States, 704 F.2d 373 (7th Cir. 1983). In a separate case involving Conrail cancellations of the same period, the Commission has just been upheld in its determination not to require the reinstatement of cancelled routes absent a showing that prescription would produce more efficient routings. Pittsburgh and Lake Erie Railroad Co. v. I.C.C., 796 F.2d 1534 (D.C. Cir. 1986).

Contract Rates

Section 208[53] of the Staggers Act provides the freedom to price rail services through individual contracts. This significant break with traditional practice was intended to produce efficiency by permitting carriers to tailor rates and services to distinct needs and differing competitive circumstances. The Commission is provided just sixty days for the review of contract filings, and challenges to contracts are permitted on limited grounds. Congress amended the contract rate provisions in 1986 as part of the enactment of the Conrail Privatization Act.[54] The amendments provided for additional disclosure of the terms of agricultural contracts (other than forest products and paper),[55] and more liberal discovery for shippers challenging contracts. The new law also required that the Commission's Contract Rate Advisory Service undertake a study of the impact on competition among agricultural shippers of the contract rate provisions.

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[52] Changes in Routing Provisions- Conrail - July, 1981, served September 5, 1986.

[53] Pub. L. No. 96-448, sec. 208, 94 Stat 1908.

[54] Pub. L. No. 99-509, sec. 4051; full act entitled, Omnibus Budget Reconciliation Act of 1986.

[55] Hereafter, the contracts affected by the Conrail Privatization Act amendments covering limited agricultural contracting will be referred to as "grain" or "grain contracts."

Rail contracting is one of the most significant developments effected by Staggers enactment. Increasingly high percentages of traffic are carried under contract rates. Estimates for coal and grain indicate that contract carriage covers more than sixty percent of the rail traffic for each. As the following table indicates, contracting has grown at a rapid rate since its inception.

Summary of Contract Rate Activity
October 1980 to December 1986

Period Ending[56]	Contracts Filed	Monthly Average
Dec 1981	768	51
Dec 1982	3,248	271
Dec 1983	8,285	690
Dec 1984	7,751	646
Dec 1985	12,448	1,037
Dec 1986	15,229	1,269

Contract terms and conditions are varied and include individualized rates, service options, investment apportioning, and numerous other features designed to meet particular needs. While the majority of contracts are drawn for periods of one year or less, multi-year contracts, some covering periods of twenty years or more, are not uncommon. A breakdown of all contracts by major commodity groups follows.[57]

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[56] The period ending December 1981 is for the 15 months commencing with Staggers enactment in October 1980.

[57] The number of private agreements for coal transportation is understated due to an exemption from filing between September 1983, and May 1985. Similarly, the number of agreements for forest products, lumber, and paper is understated due to the

Contract Rate Activity
By Major Commodity Group
1980-1986

Commodity	Number	Percent
Bulk Products, Chemicals, Minerals.................	16,186	34
Forest Products, Lumber Paper....................	4,851	10
Grain....................	11,073	23
Foodstuffs...............	3,599	7
Iron and Steel, Metals, Scrap....................	5,766	12
Coal.....................	2,634	6
Auto, Parts, Machinery, Implements..............	1,201	3
Misc. Commodities, Services.................	2,419	5

Rail contracting is frequently cited as the most beneficial aspect of the Staggers Act reforms. What concerns have been expressed have largely centered around the possibility of discrimination favoring large grain shippers. Contracts filed with the ICC are confidential, except to the extent disclosed by summaries published by the ICC, or to the extent "discovered" by a complainant in the course of litigation. Dissatisfaction with the degree of disclosure and the availability of discovery[58] led to the passage of the grain contract provisions in the last

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exemption from regulation (including contract filing) of boxcar traffi

[58] The Commission's original rules for disclosure and discovery were affirmed on the disclosure issues, and remanded on the issue of discovery. Water Transport Association v. I.C.C., 722 F.2d 1025 (2d Cir. 1983). The Commission issued interim rules governing discovery in July 1984, but held further action in abeyance, pending negotiations between shipper and rail groups.

session. Interim rules implementing the Congressional amendments were made effective in January 1987.59

To comply with the new law, the Commission made changes to its contract rate summary and discovery rules for grain commodities. As to summaries, we required additional disclosure including the shipper's identity, specific origins and destinations, shipper facilities, duration, actual volume, effective date of contract (whether before or after filing), and the tariff provision that would apply in the absence of the contract. To liberalize discovery, the Commission initiated a new informal discovery process, liberalized the tests governing who might discover a grain contract, and eliminated filing requirements that had made discovery burdensome to potential protestants. (60)

The Commission also took steps to liberalize its rules for non-grain shippers not covered by the 1986 amendments. More disclosure in the contract summaries was ordered, including origin and destination information, and data regarding effective dates. Non-grain discovery rules were also revised, although a pre-discovery showing of need for information was retained for these commodities.

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[59] Ex Parte No. 387, Rail Transportation Contracts, served December 19, 1986; as modified by order of Chairman Gradison, served January 22, 1987.

[60] Parties seeking discovery of grain contracts no longer have to show likely injury, need for specific information, or the fact of a prior attempt to negotiate a similar contract. (Railroads are immune from most agricultural protest if they have offered a similar contract to the protestant.)

It is too soon to make any hard determinations on the impact of the new disclosure and discovery rules. Protest against contracts and requests for discovery have been quite rare in the past. There have been fewer than twenty such instances, compared to contract filings that now exceed 50,000. Whether the liberalization of the disclosure/discovery rules results in a change in the number of protests, or whether it will have a more direct impact on contracting per se, will be monitored closely by the Commission's Contract Rate Advisory Service.61 As of June 1, there have been no requests for discovery under the liberalized rules.

Section 4051 of the Conrail Privatization Act also required that the Commission undertake a study of the competitive effects of grain contracting. A notice requesting public comment was issued on November 17, 1986. Additionally, recognizing the difficulty in obtaining responses from small shippers, we retained the services of consultants to survey shippers in the major grain producing states of Illinois, Indiana, Iowa, Kansas, Minnesota, Nebraska, North Dakota, Oregon, South Dakota, Texas and Washington. Based on the analyses of the comments and the

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61 One potentially troubling statistic has already been noted. Prior to the implementation of the January 1987 rules, contracts for grain -- grain is the commodity most fully affected by the new law and the agency's new rules -- had typically accounted for 23 percent of all contract activity. For the period between the end of January and the end of March, grain contracts fell to below 9% of all filings. Whether the decline reflects a bunching of contracts in the period just before the imposition of new disclosure requirements, or whether there is some long-term significance is not yet apparent.

state surveys, the Commission's Contract Rate Advisory Service overall assessment was that:

> Many small country elevators are disadvantaged by the high volume contracts of larger elevators. However, these disadvantages would still be encountered under a tariff system where reduced rates for multiple car and unit train shipments are permitted.
>
> Most large shippers and receivers of grain use contracts extensively and the impact of contracts on their position in both domestic and foreign markets has been favorable.
>
> Overall, farmers have benefitted from contracts because contracts have resulted in higher prices being paid for grain.

Abandonments

Abandonment of rail lines slackened again in the past year, and the total mileage abandoned in Fiscal 1986 is the lowest since shortly after the 4R Act enactment in 1976.[62] It is impossible to predict whether further declines are probable, but two factors point in that direction. Carriers have used the freedoms provided by Staggers, the 4R Act, and the Northeast Rail Services Act to cull out the most obvious candidates for abandonment. There obviously were incentives to eliminate the most unprofitable lines first. Increasingly, carriers are faced with more problematical choices.[63] Given a flexible regulatory climate that permits a carrier to make the most of its marginal lines, abandonment may not be the preferred choice. Somewhat related to this first point is the fact that Class I carriers are also selling lines to new operators as an alternative to abandonment. This development, discussed below in more detail, is of great potential consequence for the maintenance of rail service.

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[62] Total track abandoned in FY 1978 was 2416 miles. Abandonments apparently peaked in FY 1982 at 5151 miles. For FY 1986, the comparable figure is 2087.

[63] In FY 1986, the Commission denied 4 abandonment applications involving 147 miles of line. Both these figures represent the second highest yearly totals since Staggers enactment, in part due to the fact that the many of the more obvious cases have

The Commission took two important actions in the 1986-87 period that should be of interest. In Ex Parte No. 274 (Sub-No. 11), Abandonment Regulations -- Costing,64 the Commission adopted changes in its abandonment and subsidy regulations that should be of benefit to shippers. The new rules no longer recognize a carrier's return on investment in locomotive and freight cars as an avoidable cost. The costs are recognized as opportunity costs, but are not considered in estimating the line's direct profitability. In Ex Parte No. 274 (Sub-No. 16), Exemption of Rail Line Abandonments or Discontinuances - Offers of Financial Assistance, the Commission tentatively concluded that financial assistance procedures should be made available even in instances where full exemption from the abandonment provisions is otherwise available. These proposed rules, which are being applied pending final decision, broaden the application of the financial assis-

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already been heard.

64 Served January 23, 1987.

tance provisions contained in section 402 of the Staggers Rail Act.[65]

Short Line and Regional Railroads

The 1986-87 period continued to be one of rapid growth for short line and regional railroads. The Commission's Office of Transportation Analysis (OTA) has been actively studying these developments and has to date surveyed 162 of the new operators, and has recently met on site with labor representatives and employees of most of the larger, regional railroads. As the growth of the short line industry is still fluid, no categorical conclusions from this study will be offered. Some important observations can be made.

Since passage of the Staggers Rail Act, there has been an unanticipated growth in short line and regional carriers. The carriers surveyed by OTA operate 10,955 miles of line, equal to approximately 7.5 percent of the total railroad mileage operated in 1985. The total work force on these carriers is above 3,000 employees, about 1 percent of the size of the work force on Class I railroads. Short lines were contacted in 34 states, but the heaviest concentration is found in the Northeast and the South. Regional railroads are more likely to be found in the South and Midwest. Much of the track of the smaller lines would have been abandoned but for the short line operator. While part of the trackage of regional carriers would have been targeted for abandonment, these lines also include some medium density markets.

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[65] The Commission also reissued its Ex Parte No. 274 (Sub-No. 8) rules governing the exemption of out of service rail lines from the abandonment application process. Reconsideration of these rules was required by judicial remand in Illinois Commerce Commission v. ICC. (787 F.2d 616 (D.C. Cir. 1986)) These rules provide for efficient processing of lines that have been out of service for two or more years.

Distribution of Surveyed Carriers by Mileage

Length (miles)	Number of Railroads	Total Miles	Percentage of Total Miles
0-5	27	74	.7
6-10	15	128	1.2
11-25	30	479	4.4
26-50	38	1,309	11.9
51-75	12	729	6.7
76-100	13	1,122	10.2
Over 100	27	7,114	64.9

In Ex Parte No. 392 (Sub-No. 1), Class Exemption for the Acquisition and Operation of Rail Lines Under 49 U.S.C.10901,[66] the Commission created a mechanism which facilitates the formation of new lines and reduces regulatory burdens, in keeping with the Staggers Act goal of encouraging new entry, preserving service, and minimizing regulations not necessary to prevent the abuse of market power. The class exemption provides that an acquisition may go forward seven days after notification to the Commission. Where there is opposition, petitions to revoke or to stay will be heard by the Commission.[67] The decision to promulgate a class exemption was taken after extensive experience with the formation of new carriers, involving more than one hundred proceedings between 1981 and 1986. This experience demonstrated uniformly that the public convenience would be enhanced by the preservation of service and jobs, and that little shipper or community opposition was likely.

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[66] Served, January 15, 1986.

Labor protection, committed to Commission discretion in new acquisitions by non-carriers, is not automatically granted under the class exemption, following the practice developed with individual applications. The Commission determined that the costs of labor protection were generally not warranted, given the absence of any record of significant labor harm in the more than one hundred cases that had been processed individually. The probability that such costs would forestall the development of these lines, thereby risking loss of rail service and continued decline in rail employment, was considered controlling. The agency did, however, provide that it would impose protection if shown to be necessary in a particular case. This has been a contentious issue. The class exemption was recently affirmed by the circuit court for the District of Columbia[68] and individual transactions have been appealed on labor protection issues.[69]

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[67] Petitions to revoke have been filed in seven acquisitions processed under the class exemption.

Mergers and Intermodal Acquisitions

The Commission approved a joint application of the CSX Corporation (CSX) and Sea-Land Corporation for the acquisition of control of Sea-Land by CSX.[70] CSX controls the Chessie system railroads and American Commercial Barge Lines. Sea-Land is a holding company providing containerized traffic between the contiguous 48 States and foreign markets. The Commission found that the application did not contravene Federal law, and that the relationship between rail carriage and ocean movement of containerized freight may be developed advantageously to the firm's and the public's interest.

In Finance Docket No. 30400, involving the proposed merger of the Sante Fe and Southern Pacific Railroads, the Commission currently has before it the question of whether it should reopen the proceeding. On October 10, 1986, the Commission served a decision denying the proposed merger. The applicants have sought reopening of the proceeding and presented evidence in support of their request, including agreements that have been concluded with rail carriers that were formerly opposed to the merger. Other carriers and the Department of Justice are, or remain, opposed to the merger. The Commission heard oral argument on the question of reopening on May 14, 1987.

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[68] *Illinois Commerce Commission v. I.C.C.*, D.C. Cir. No 86-1107, argued May 7, 1987, Commission aff'd. without opinion May 12, 1987.

[69] *See*, *e.g.*, *Railway Labor Executives' Ass'n v. United States*, 811 F.2d 1327 (9th Cir. 1987) (affirmed in part, remanded in part); *Pennsylvania State Legislative Board v. I.C.C.*, No 86-3231 (3rd Cir. Dec. 2, 1986) (individual exemption affirmed without opinion).

[70] Finance Docket No. 30900, *Joint Application of CSX Corporation and Sea-Land Corporation Under 49 U.S.C. 11321*, served February 24, 1987. A related exemption application involving motor carrier subsidiaries of Sea-Land was held in abeyance.

In a second rail merger proceeding, the Commission is considering the application of the Union Pacific Corporation for control of the Missouri-Kansas-Texas Railroad.[71] A procedural schedule has been established and the case is before an agency administrative law judge.

Rail carriers continued to show interest in the acquisition of motor carriers. Union Pacific Corporation (parent of the Union Pacific Railroad Corporation) filed an application for control of Overnite Transportation Company.[72] The application was accepted by the Commission on January 20. July 17 is set for the close of the record. Opposition appears limited. Overnite is a large less-than-truckload carrier operating primarily in the eastern two-thirds of the nation.

The Burlington Northern also sought, through exemption, the control of six motor carriers.[73] These exemptions were granted by the Commission after it was determined that they were limited in scope and would not result in the abuse of market power.

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[71] Finance Docket No. 30800. Application filed November 11, 1986. Procedural schedule served March 3, 1987.

[72] Finance Docket No. 31000, Union Pacific Corporation-Control - Overnite Transportation.

The status of rail/motor acquisitions was clouded somewhat by a court reversal of the 1985 Norfolk Southern Corporation acquisition of North American Van Lines.[74] The court reversal was in turn reversed by action of the Congress in the Omnibus Drug Enforcement, Education and Control Act of 1986.[75] The Omnibus Drug Act approved the Commission's guidelines for analysis of the Norfolk Southern application (in essence guaranteeing its legality),[76] and also provided that the same standard of review may be applied in the Union Pacific/Overnite transaction. Its impact on the Burlington Northern cases, if any, is not clear.

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[73] No. MC-F-16248, Burlington Northern, Inc. - Control Exemption - Victory Freightway Systems, Inc., served February 13, 1986; No. MC-F-17301, Burlington Northern Inc. and Burlington Northern Motor Carriers, Inc. - Control Exemption - Stoops Express, Inc., Wingate Trucking Company, Inc., and Taylor-Maid Transportation, Inc., July 28, 1986.

[74] International Brotherhood of Teamsters, Chauffeurs and Warehousemen and Helpers v. I.C.C., 801 F.2d 1423 (D.C. Cir. 1986); petition for rehearing filed November 14, 1986.

[75] Pub. L. 99-570, sec. 3403 (1986).

[76] The acquisition was sustained on petition for rehearing. International Brotherhood of Teamsters v. I.C.C., supra, May 8, 1987.

Car Service Compensation

Car service compensation is a catch-all term used to cover the compensation that railroads pay to one another for the use of freight cars (per diem car hire payments) and to shippers for the use of shipper-owned cars (mileage allowances). Freight car shortages had been a serious problem in the decade preceding the 4R Act and the Staggers Act. Section 224 of the Staggers Act was directed to car compensation. It repealed the "incentive element" provision that had explicitly given the Commission authority to impose incentive payments when car types were in short supply. It also provided explicit antitrust immunity for collective negotiations among shippers seeking agreement on car service compensation levels. The Conferees stated that the incentive element was not the best means of attracting capital, that the basic rates should be adequate, and that the Commission should continue to examine means (the Conferees specifically mentioned flexible car hire) for making car compensation more responsive to market forces.77 The Commission has had several occasions to address car compensation issues in the past 18 months.

In Ex Parte No. 346 (19), Boxcar Car Hire and Car Service, 78 the Commission adopted changes to the rules under which rail carriers compensate one another for the use and handling of each others boxcars. The new rules are designed to produce

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[77] H. Rep. No. 1430, 96th Cong., 2d Sess., 117 (1980).

[78] Served September 12, 1986.

greater efficiency in the boxcar fleet by creating incentives for the negotiation of bilateral agreements. Explicit protection is included for the boxcar fleets of smaller carriers that had protested earlier attempts at modernizing the per diem formula.[79]

In Ex Parte No. 328, Investigation of Tank Car Allowance System,[80] the Commission adopted a negotiated agreement between the railroad industry and the major suppliers of tank cars. The agreement is designed to improve the responsiveness of tank car allowances to supply and demand considerations, and it provides that carriers bear the burden of proof in certain contested instances of deviation from the national formula. In a related complaint proceeding, the Commission found deviations from the pre-existing formula were not authorized and ordered the filing of evidence and argument on whether reparations were warranted to shippers that had received reduced mileage payments. [81]

Finally, the Commission voted in open conference in February 1987 to decline a request to impose a mandatory uniform mileage allowance nationwide for the use of shipper-owned hopper cars.[82] A decision in this case is under preparation. In a related proceeding, the Commission's award of reparations to shippers that had received reduced mileage payments under an unlawful mileage cap was affirmed after judicial review. 83 While reparations had been awarded, it was the shippers who took the Commission to court, claiming that the Commission had not gone far enough towards mandating compensation based solely on the cost of car ownership.

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[79] Section 4052 of the Omnibus Budget Reconciliation Act of 1986, supra, provides that the the "portion of the rule adopted...in Ex Parte 346 (Sub-No. 19)...consisting of small railroad protections, is hereby affirmed."

[80] Served September 26, 1986.

[81] No. 39909, Cap on Mileage Allowance for Use of Privately Owned Tank Cars, SP, February 4, 1987.

[82] No. 39117, Lo Shippers Action Committee v. Aberdeen and Rockfish Railroad Company, Conference of February 24, 1987.

Conclusion

This concludes the Commission's written statement. The principal points that we hope to have made are that, first, the Staggers Act is working well for nearly all concerned, and second, the Commission is actively working to maintain a balanced set of regulatory policies that will provide carrier flexibility, but protect shippers that are presently without alternatives. The number of problems appears to be receding, as one would expect, with the accumulation of experience with new marketplace opportunities, and with a better understanding of the Commission's standards for remedial regulation.

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[83] Lo Shippers Action Group v. I.C.C., No. 86-1037 (D.C. Cir., Nov. 7, 1986) dismissing petitions appealing No. 39908, Mileage Allowances for Covered Hoppers, Grain and Grain Products, BN, served December 5, 1985.

Separate Expression

Commissioner J. J. Simmons III, commenting:

I agree that this Commission has made some progress in recent months in its continuing efforts to implement fully the provisions of the Staggers Act. Nevertheless, today's testimony is unrealistic in its claims regarding the balancing of statutory policies and the protection of captive shippers. If the Commission's record were as positive as presented here, the significant support for new rail legislation would be inexplicable.

Certain Commission positions have elicited particular concern from interested observers. On competitive access issues, a majority of the Commission has erected new barriers to access as often as it has promoted additional competition. Many abandonment applications, and particularly requests for exemptions to permit abandonments, are granted with inadequate consideration of the impact on shippers and national energy and defense concerns. Our revenue adequacy standard continues to yield unrealistic results. And the settlement of numerous rate cases, which our testimony terms "gratifying," probably resulted more from Commission delay in adopting maximum rate standards than from any genuine meeting of the minds.

Because many features of the Staggers Act demand a weighing and balancing of various interests, I strongly believe that implementation of this and other rail legislation can best be accomplished by an objective and impartial independent regulatory agency. Thus, I cannot join those of my colleagues, including the Chairman, who support the Administration's proposal to sunset the ICC and transfer our rail responsibilities to the Department of Transportation. With the necessary funding and staffing levels, and with appropriate guidance from Congress, the ICC can and will implement the reforms of the Staggers Act in a manner consistent with legislative intent.

Attachment A
Page 1 of 2

COMPARATIVE INDUSTRY ROE RANKINGS

FOR 1978 THROUGH 1986

(Ranked in 1986 Order)

Industry	1986		1985		1984		1983		1982	
		%		%		%		%		%
Tobacco	1	21.5	1	23.2	4	18.8	2	18.5	1	20.2
Beverages	2	21.0	3	19.1	8	17.0	3	17.9	4	17.2
Drugs	3	20.4	4	18.7	3	19.4	1	19.6	2	19.2
Pub/Radio/TV	4	20.2	2	20.4	6	18.0	5	16.8	6	16.6
Food Processing	5	19.8	8	16.6	9	16.3	16	13.4	11	13.5
Savings & Loan	6	18.9	9	16.0	29	9.8	15	13.7	38	-14.2
Food & Lodging	7	15.9	6	17.3	7	17.2	8	16.6	8	15.5
Automotive	8	14.0	5	18.5	1	24.3	6	16.7	35	-4.0
Personal Care	9	13.8	14	13.9	16	14.5	4	16.9	5	16.7
Trucking	10	13.5	15	13.3	12	15.5	9	15.6	20	10.7
Building Mat	11	13.2	17	12.0	23	11.4	31	7.2	33	2.8
Nonbank Finance	12	12.8	27	9.0	33	8.9	21	11.9	18	12.3
Misc Manufact	13	12.7	22	10.4	17	14.2	25	10.4	23	10.2
Retail Non Food	14	12.7	16	13.2	13	15.3	12	15.1	21	10.4
Electrical	15	12.6	18	11.8	10	16.3	14	14.4	9	15.1
Retail Food	16	12.3	10	15.7	15	14.9	11	15.2	15	12.9
Containers	17	12.0	21	11.2	24	10.5	30	7.7	28	7.7
Appliances	18	11.9	11	15.2	11	16.2	18	12.9	27	7.9
Chemicals	19	11.7	35	1.4	22	11.5	28	9.0	26	8.3
Textile/Apparel	20	11.6	30	8.1	26	10.4	17	13.1	24	9.2
Off Equip/Comps	21	11.5	12	14.7	5	18.1	7	16.6	7	15.9
Utilities	22	11.3	20	11.5	19	13.1	22	11.7	17	12.7
Banks	23	10.6	19	11.6	32	9.2	23	11.6	16	12.7
Service Ind	24	10.4	24	10.0	18	13.9	19	12.7	13	13.0
Telecommunications	25	10.3	--	----	--	----	--	----	--	----
Paper/Forest Prods	26	9.9	29	8.2	31	9.5	32	7.0	31	3.9
Leisure Time	27	9.5	26	9.1	27	10.4	34	4.0	10	14.1
Aerospace	28	9.4	7	16.9	2	20.3	10	15.3	14	12.9
Real Estate/Housing	29	9.4	13	14.3	35	7.8	13	14.9	29	6.3
Instruments	30	8.5	25	9.8	14	14.9	24	10.7	22	10.3
Nat Resources	31	7.6	23	10.4	21	12.5	20	12.3	12	13.1
Airlines	32	6.3	32	6.7	30	9.8	36	-2.5	37	-8.9
Special Machinery	33	4.2	33	5.5	38	.6	37	-3.2	34	.0
RAILROADS	34	4.2	31	7.7	25	10.4	26	10.2	25	8.7
Metals & Mining	35	3.5	39	-12.6	39	-1.5	38	-3.2	36	-5.8
Tire & Rubber	36	3.5	36	1.1	28	9.8	29	8.4	30	5.3
Gen Machinery	37	1.1	34	2.7	34	8.2	35	1.1	32	3.8
Conglomerates	38	-1.4	28	8.9	20	13.1	27	10.0	19	10.8
Oil Service/Supply	39	-21.5	37	1.0	36	6.5	33	6.7	3	18.0
Steel	40	-29.9	38	-2.5	37	1.3	39	-21.4	39	-19.0

Data for telecommunications industry does not exist prior to 1986.

1986 railroad ROEs exclude certain special charges taken during the year which significantly reduced net income. These excluded special charges are for the railroads only and do not exclude special charges for non-rail operations.

SOURCE: BUSINESS WEEK (Annual "Corporate Scoreboard" Issues)

Attachment A
Page 2 of 2

COMPARATIVE INDUSTRY ROE RANKINGS

FOR 1978 THROUGH 1986

(Ranked in 1986 Order)

Industry	1981		1980		1979		1978	
		%		%		%		%
Tobacco	2	19.9	3	21.5	7	20.5	9	19.7
Beverages	10	15.4	13	17.0	28	14.6	32	13.2
Drugs	3	18.7	5	20.1	5	20.8	4	20.4
Pub/Radio/TV	6	17.2	33	8.3	3	21.3	2	20.9
Food Processing	15	14.9	18	15.6	26	15.4	27	14.8
Savings & Loan	39	-8.6	35	6.1	27	15.4	14	18.4
Food & Lodging	7	17.1	10	18.5	17	17.1	17	18.1
Automotive	37	-4.0	39	-11.1	35	11.3	19	16.8
Personal Care	5	17.7	9	19.1	13	18.2	7	20.0
Trucking	21	13.9	23	14.6	20	16.9	1	21.4
Building Mat	36	7.0	32	10.9	24	15.6	18	16.9
Nonbank Finance	18	14.5	17	15.9	18	17.1	11	18.8
Misc Manufact	17	14.6	15	16.3	11	19.3	21	16.0
Retail Non Food	26	12.5	31	11.5	30	14.5	26	14.9
Electrical	9	15.9	7	19.3	9	19.7	12	18.6
Retail Food	14	15.1	24	14.5	25	15.5	24	15.4
Containers	31	10.7	27	12.9	32	13.4	35	12.1
Appliances	30	10.8	28	12.7	36	9.3	22	15.7
Chemicals	23	13.1	21	15.3	19	17.1	28	14.4
Textile/Apparel	28	11.4	29	12.7	31	13.5	34	12.7
Off Equip/Comps	12	15.2	8	19.2	8	19.8	5	20.4
Utilities	20	14.0	26	12.9	34	12.8	33	12.7
Banks	22	13.6	22	14.9	29	14.6	29	14.3
Service Ind	16	14.9	4	20.5	12	19.3	16	18.2
Telecommunications	--	----	--	----	--	----	--	----
Paper/Forest Prods	29	11.0	30	12.6	15	17.7	23	15.5
Leisure Time	13	15.2	14	16.4	14	18.0	10	18.8
Aerospace	8	15.9	6	19.5	1	21.7	6	20.3
Real Estate/Housing	35	7.1	11	18.3	4	21.0	15	18.4
Instruments	24	12.7	19	15.4	23	15.9	25	15.3
Nat Resources	4	18.6	2	23.8	2	21.5	30	13.9
Airlines	38	-5.9	38	-.3	38	6.8	8	20.0
Special Machinery	27	12.5	25	13.4	21	16.5	13	18.4
RAILROADS	25	12.5	36	3.9	33	12.9	37	9.3
Metals & Mining	34	9.0	12	18.1	10	19.4	36	10.0
Tire & Rubber	33	9.2	37	3.7	37	7.8	39	5.4
Gen Machinery	19	14.1	20	15.3	16	17.5	20	16.3
Conglomerates	11	15.4	16	16.1	22	16.0	31	13.5
Oil Service/Supply	1	24.8	1	24.2	6	20.6	3	20.5
Steel	32	9.4	34	7.8	39	5.4	38	7.8

Data for telecommunications industry does not exist prior to 1986.

SOURCE: BUSINESS WEEK (Annual "Corporate Scoreboard" Issues)

ATTACHMENT B

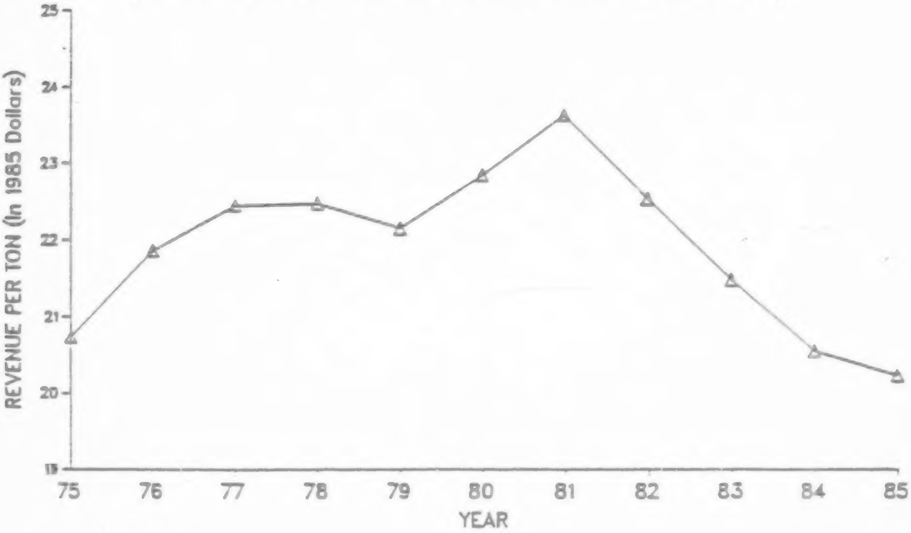
RAIL RATES HAVE DECLINED SINCE STAGGERS

The following graphs show recent trends in inflation adjusted rail rates overall and for each of the seven major commodities that constituted 73% of total rail freight in 1985. The remaining 27% of rail traffic is grouped together as the final graph. Results are remarkably consistent. Rates were rising before Staggers and since then the increase has slowed and been reversed.

Average revenue per ton of freight carried by class I railroads is the rate measure chosen. This approach allows virtually all rail traffic to be included in the measure rather than just a small sample. In addition, it captures the effect of rate reductions made possible by the use of contracts and multi-car shipments. Railroads have used the pricing freedom of Staggers to offer contracts and volume discounts that allow more efficient service. In this way, shippers and railroads share the benefits of Staggers.

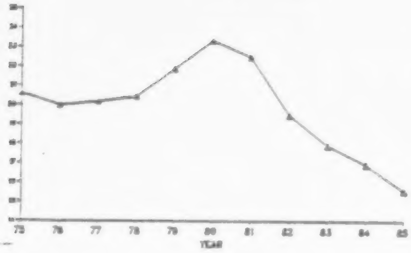
Revenue per ton was used in an effort to be conservative. In recent years the average distance shipped on Class I railroads has increased, from 616 in 1980 to 664 miles in 1985. As a result, using revenue per ton makes the rail rate picture look worse (or not as good) as it really is.

AVERAGE FOR ALL COMMODITIES
1975 – 1985
(IN CONSTANT DOLLARS PER TON*)

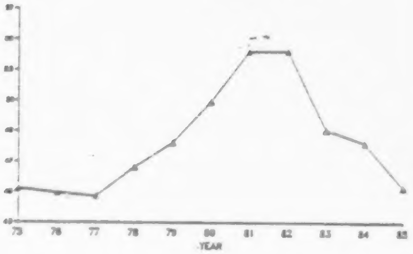


*DEFLATED USING GNP DEFLATOR.

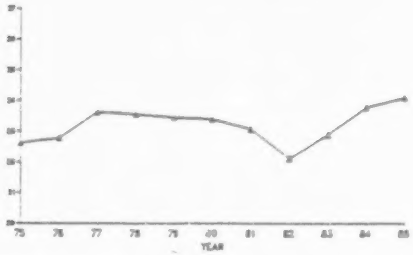
REVENUE PER TON IN 1985 DOLLARS*



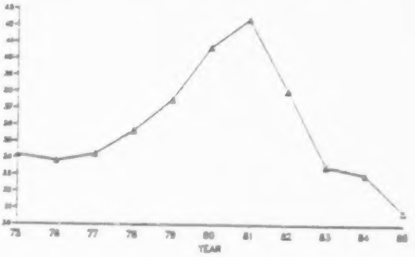
FARM PRODUCTS
1975 – 1985



PAPER AND PULP
1975 – 1985



LUMBER
1975 – 1985

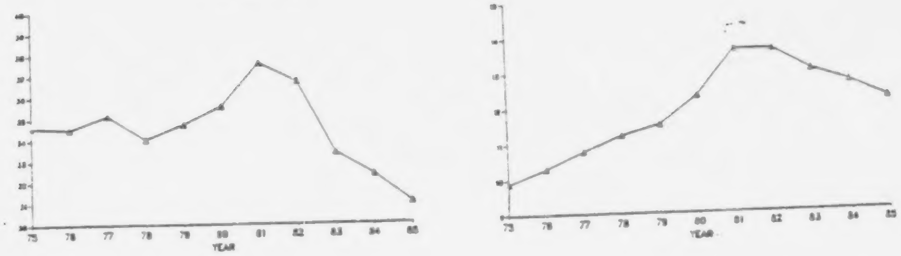


FOOD
1975 – 1985

Farm products, paper and pulp, and food all had sharp drops in rates after Staggers which followed increases in the earlier years. Revenue per ton dropped 33%, 11%, and 24%, respectively for these commodities between 1980 and 1985. The only major commodity which has not shown any real improvement since Staggers is lumber. Revenue per ton did drop immediately following Staggers but has since increased. Lumber is also the lowest rated of the major commodities. Its average revenue is barely over variable cost.

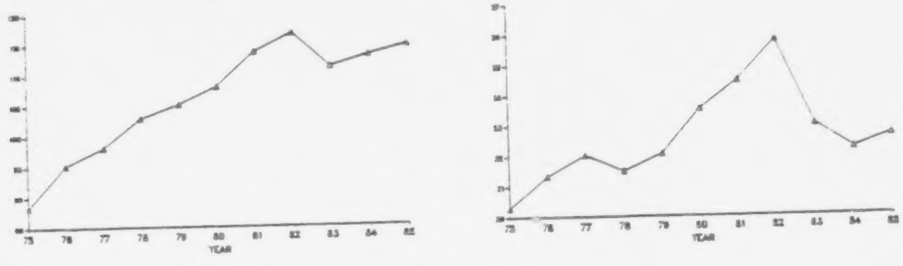
*DEFLATED WITH GNP DEFLATOR

REVENUE PER TON IN 1985 DOLLARS*



CHEMICALS
1975 – 1985

COAL
1975 – 1985



TRANSPORTATION EQUIPMENT
1975 – 1985

ALL OTHER COMMODITIES
1975 – 1985

Chemicals, coal and all other commodities showed the typical pattern of increases prior to Staggers and decreases afterwards. Between 1980 and 1985 revenue per ton dropped 12% for chemicals and 4% for all other commodities. During that period the reduction for coal was only 1% but between 1981, when coal revenue per ton peaked, and 1985 the reduction was 11%. Transportation equipment (mostly automobiles and parts) failed to decline but the sharp escalation prior to Staggers was halted. Revenue per ton, which has increased as a result of shifts to smaller cars and just in time shipments, peaked in 1982.

*DEFLATED WITH GNP DEFLATOR

Attachment C

Comparative 1985 Rates of Return Before and After adjustment For Depreciation and Deferred Taxes Per Ex Parte 393 (Sub-No. 1)

	Before (Old Rules)	After* (New Rules)
B&O	-2.92%	-1.17%
B&M	-0.36%	2.05%
C&O	-2.52%	-0.10%
Conrail	3.76%	6.08%
D&H	-8.97%	-4.74%
EJ&E	0.13%	-1.56%
GTW	-1.34%	1.64%
N&W	5.12%	9.05%
FEC	5.50%	5.47%
ICG	-2.69%	2.37%
SBD	-1.28%	1.29%
SOU	5.90%	8.06%
AT&SF	1.36%	4.29%
BN	7.97%	10.29%
C&NW	-1.40%	0.43%
D&RGW	2.59%	5.62%
KCS	7.51%	9.23%
MKT	2.10%	2.17%
MoPac	3.40%	6.21%
SLSW	4.00%	3.19%
Soo	2.28%	1.46%
SoPac	-4.64%	0.67%
UnPac	4.69%	7.34%
WePac	-7.87%	-3.22%

* Does not reflect all of the modifications adopted by the Commission in Ex Parte No. 393 (Sub No. 1). The impact of two modifications (one relating to combined data for Class I carriers under common control and the other relating to consolidated data for the Class I carrier and its rail-related subsidiaries) could not be determined since the required information is not presently reported by the railroads.

Attachment D

Recent Public Utility Estimates
Of Return on Equity

Utility Decisions Sep-Dec 85

Utility Name	Date	ROE Requested	ROE Received
Brooklyn Union Gas	9/85	16.2	13.8
NY Telephone	10/85	16.2	14.0
Oklahama Gas	12/85	16.8	14.5
Sou Bell Georgia	9/85	16.5	15.0
Duke Power	9/85	16.3	14.9
Atlanta Gas	9/85	17.3	15.3
Monaganela Power W VA	10/85	16.0	14.0
Bell Penn	10/85	16.5	15.2
Sierra Pacif Power Nev	10/85	16.8	14.3
Ohio Bell	12/85	16.6	14.6
San Diego Gas & Elec	12/85	16.5	15.0
AVERAGE		16.5	14.6

SOURCE Public Utilities Fortnightly, Various Issues, Jan-Feb 86

INTERSTATE COMMERCE COMMISSION

ANALYSIS OF S. 676,
THE CONSUMER RAIL EQUITY ACT

ANALYSIS OF S. 676
CONSUMER RAIL EQUITY ACT

(Sections 1 and 2, Title and Purpose, require no commentary. Analysis begins with section 3.)

Section 3: Market Dominance

S. 676 would amend the definition of market dominance. Beginning with the 4R Act, the regulation of rates is limited to instances where there is a lack of effective competition that can be relied on to obviate the need for Federal supervision. S. 676 would define effective competition as point-to-point competition from other carriers for the same commodity. The bill would also enact the proposition that competition at the destination does not establish effective competition at the origin, and vice versa. These latter propositions appear to be vestiges of earlier bills; they are logically superfluous once effective competition has been defined as point-to-point, the same commodity from the same origin to the same destination. Consequently, the substance of the S. 676 market dominance provisions is the limitation to modal, point-to-point competition. This is, in effect, a repeal of the Commission's determination, sustained by the courts, that rates can be effectively restrained by product and geographic competition.

That rates can be restrained by product and geographic competition does not seem to be a debatable proposition. Oil and gas compete against coal as fuel for electrical generation, and rail carriers, like coal suppliers, need to remain efficient and low cost to protect their markets. Furthermore, different mining regions compete with one another for coal markets, forcing price consciousness on each region's mines and transport systems. The recent reliance on "spot market" buying by many utilities is an example of how intense this competition can become. These facts are largely beyond dispute, but the sponsors of new legislation argue that not all rates are necessarily effectively restrained, and the burden of proving the absence of geographic or product competition restraint is substantial and an unnecessary bar to relief through regulated rates.

Recognizing the validity of the burden of proof issue, the Commission adopted by rule an industry agreement shifting the burden on these issues to the rail carrier defendant. (In addition, the Commission's rules also provide that no assumption of effective origin competition is automatically inferred from destination competition etc. This is an appropriate concept where the definition of effective competition is not limited to point-to-point carriage.) There have been very few instances of reliance on geographic or product competition for dismissal of rate complaints, though there have been some. Nevertheless, the concepts are extremely important gatekeepers. Shippers served by alternative carriers and modes with differing sources or destinations now use self-help measures to examine their market alternatives and find leverage. The excessive reliance on regulatory litigation has been diminished sharply. Marketplace solutions increase efficiency and help carriers, shippers, and the public alike. If these gatekeeping disincentives to litigation are removed, and, particularly, if the removal is coupled with new ratemaking standards designed to reduce the level of allowable rates, a return to needless litigation and over-regulation is almost certain.

Section 4: Rate Reasonableness

Section 4 of S. 676, Rate Reasonableness, effects changes in the burden of proof in rail rate investigations and in the standard by which the reasonableness of a rate is to be judged. The burden of proof is shifted to the rail carrier in all instances. The standard is changed to reduce the emphasis on revenue adequacy, to call into question the need for rates above the jurisdictional threshold, to stress the "actual" cost of service, and to re-emphasize the efficiency and equity considerations presently codified at 49 U.S.C. 10707a(e)(2)(C) (Long-Cannon factors). The Commission is charged with completing a proceeding to implement this section within 360 days of enactment.

Burden of Proof

Prior to 1980, the burden of proof in a rail rate case was generally on the complaining party. This approach is consistent with civil litigation practice where the burden of proof traditionally falls on the complaining litigant. Under pre-Staggers law, an exception was made for shippers where the Commission made an initial determination that a proposed rate was suspect. In these "investigation" cases, the rail carrier was required to carry the burden.[1] Staggers limited the instances where this exception might apply, in essence shifting more of the burden to shippers.[2]

The proposed bill would undo the Staggers amendments, and repeal the earlier arrangement as well. Once market dominance were found, the burden of proving the reasonableness of a rate would always be on the carrier. Coupled with the change in standards outlined below, the shift of burden could substantially limit the degree of differential pricing over the jurisdictional threshold, even in cases where abuse is not evident. In 1976, Congress made a similar shift in the burden of proof regarding the special provisions which govern the reasonableness of rates for recyclable materials. The Commission did not initially interpret this burden shift to have broad decisional consequences, but its view was overturned in court. According to the circuit court reviewing recyclable rules, "By reversing the burden of proof...Congress accomplished more than a mere change in procedural format.... [I]t erected an evidentiary presumption against the lawfulness of the rate structures, thereby preventing the Commission from assuming, or otherwise deferring to, asserted revenue needs of the railroads in determining the lawfulness of the rates." 3 Given the proposed changes in decisional standards and in the National Transportation Policy, there is more than a substantial likelihood that pricing above the jurisdictional threshold will become difficult to defend, if the recyclables precedent is an indicator of court viewpoint. The magnitude of impact would be further increased by the limitation of the gatekeeping function of the market dominance concept discussed above. New Standards

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[1] Technically, the burden is shifted to a carrier if the Commission decides to suspend or investigate a rate proposal before it becomes effective, typically after protest by a shipper. There has never been any explicit standard governing the decision to investigate a new proposal, but in the 4R Act Congress declared that the related decision to suspend should be based on a protestant's demonstration of probable success on the merits. Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, sec. 202, 90 Stat. 34. Consequently, such a decision amounts to an initial statement that the Commission suspicions that the proposed rate will not be approved. In these circumstances, a shift in the burden is justifiable. If the Commission decides not to investigate or suspend, a shipper may still bring a case -- a "complaint" lodged against a now existing rate, as distinguished from the original "protest" of the proposed rate -- but the burden is on the complaining shipper.

[2] Under Staggers, there are some "protest" investigations (see note 1 above) where the burden is on the shipper, despite the initial decision of the Commission to investigate. These instances involve increases taken under the cost recovery provisions of Section 10707a, where the resultant rate does not exceed 190 percent of variable costs.

Staggers introduced a new provision, section 10701a, which contains an explicit new standard by which rail rates are now governed. The standard is that, in determining the

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[3] National Ass'n of Recycling, Etc. v. I.C.C. 585 F.2d 522, 533 (D.C. Cir. 1978).

reasonableness of a rate, the Commission shall recognize the policy of Title 49 that rail carriers shall earn adequate revenues. This language would be repealed by S. 676. The substitute language makes it an issue in every case as to whether revenue adequacy is needed. What is now a policy given is to become a matter for debate. The Commission is to make affirmative findings, based on a burden to be carried by the rail carriers. It cannot be assumed that a need for revenue adequacy will always be sustained. Changes in the National Transportation Policy, discussed below, are certainly open to the interpretation that rail carriage should subsidize production in other industries, and the elimination of the revenue adequacy reference in subsection 6 of that Policy can also be construed as a limitation on the desirability of fostering a healthy rail system.

Even where revenue adequacy is found necessary, the Commission is further required to determine if it can be attained without rates above the jurisdictional threshold, and, again, the rail carriers have the burden on this issue. This requirement is logically coupled with the need for affirmative findings on Long-Cannon issues of pricing efficiency and equity. In combination, these two requirements impose on the defending carrier the need to demonstrate that all of its rates are optimal and that its operations are uniformly efficient. Since defendants bear the burden on these issues, the Commission will be hard pressed to make simple common sense deductions about the profit-maximizing incentives of competitive firms. (See text referenced by note 3 above.) Consequently, each rate case has the potential to become an open-ended inquiry into a carrier's pricing and investment decisions. The cases would be complicated further by the requirement to consider "actual" costs. In the context of existing Commission policy, "actual" costs would appear to be a repudiation of any of the differential pricing caps in the coal and non-coal guidelines. Consequently, the Commission would again have to consider the basis on which fixed costs of rail service might be allocated. Such an undertaking will embroil rail ratemaking in another lengthy up and down litigation battle. The administrative burden thus encountered is the antithesis of the Staggers goal of reduced regulation.

The existing standards and procedures are clearly superior to those proposed. Revenue adequacy considerations are relied upon to permit a degree of differential pricing, capped by workable gauges of market abuse. The burden on shippers has been reduced by administrative rulemaking -- first in market dominance, and recently in the reasonableness phase of non-coal and small shipper cases. Long-Cannon considerations are enlarged by the management efficiency provisions of the coal rate guidelines, and stand-alone costing automatically results in the elimination of the potential for cross-subsidy that brought Long-Cannon into being.

Section 5: Rail Transportation Policy

S. 676 would amend the rail transportation policy in two respects. It would eliminate reference to revenue need in subsection 10101a(6) of Title 49, and would add a new subsection (15) to encourage and promote competitive transportation rates for domestically produced coal and other commodities to encourage domestic and export sales.

The first change is potentially unobjectionable. As it now stands, subsection 10101a(6) could be interpreted to permit rates to rise to any level, as long as overall revenue inadequacy exists. The Commission does not interpret the subsection in that fashion. Commission policies reflect instead the view that individual rates must be reasonable, and that revenue inadequacy does not sanction unreasonable pricing. Consequently, this amendment is unnecessary. Furthermore, there is a potential problem with its enactment. The subsection now encourages rate flexibility where effective competition exists. However, S. 676 sharply curtails the definition of effective competition, and this fact, coupled with the removal of revenue adequacy considerations from 10101a(6), could be interpreted as a major departure from the National Transportation Policy preference for marketplace solutions.

Proposed subsection (15) can be interpreted as consistent with existing policy, or, alternatively, it can be viewed as a statement of preference for commodity traffic, singling out coal for advantageous treatment. No justification for preferential treatment has been offered.

Section 6: Inflation Based Rate Adjustments

The Rail Cost Adjustment Factor is an indexing process enacted in Staggers to prevent the erosion of profitability due to a coupling of regulatory delay and increasing inflation. This had been a serious problem prior to Staggers. General increases can now be taken based on an index of rail input factors. As the index rises from quarter to quarter, rate increases can be taken automatically. Two main areas of contention have developed regarding the index. The first concerns the effect of decreases (deflation) in the index on rail prices. The second concerns whether or not increases in factor prices should be offset by productivity gains that reduce the cost of providing service. S. 676 would require that rates fall when the index falls, and that productivity be used as an offset to factor price increases.

In 1986, the Commission revised its indexing procedures to require that future rates decline when the index declines, ordered a roll-back in existing rates to capture recent declines, and adopted an offsetting process for past declines that have not been recognized in existing rates. (S. 676 specifically provides that the Commission's authority to order these rate reductions is affirmed.) These actions represent a reversal of policy, and reflect an accommodation of an inflation-oriented provision to the up and down markets of the present decade. The difference between Commission policy and the proposed bill on these issues is marginal.

The productivity question is more difficult. The Commission has an open rulemaking to consider this issue, but problems with developing a methodology which fairly accounts for productivity gains have been substantial. The Rail Accounting Principles Board has taken the position that a productivity adjustment should be made, and that practical methodologies exist, but the Board did not indicate what such methodologies might be. Requiring the adjustment in advance of identifying workable implementation is not judicious. As the Commission has demonstrated elsewhere, shippers have been the beneficiaries of sizable productivity gains since Staggers -- rates have been falling despite cost increases. The Commission's action in banking past decreases as offsets against present increases has temporarily defused the impact of the index. Costs have been rising over the past few quarters, but no rate increases have been authorized.

Section 7: Standards and Procedures for Determining Revenue Adequacy

This section amends Section 10704 of the IC Act. The sponsors' introductory remarks indicate that they seek a "public utility commission" approach to rate regulation. They view revenue adequacy as the most important element in the law, since they believe it determines the burden carried by captive shippers.

Paragraph (a)(2) of existing section 10704 is amended by substituting the term "return" on capital in lieu of "economic profit or return (or both)" on capital.

Paragraph (3) of the existing law directs the Commission to develop standards and procedures for determining railroad revenue adequacy. It is replaced by language specifying the standards and procedures the Commission will use to assess the revenue requirements of the railroads. Specifically the Commission would be required to: (1) Consider the revenues, expenses and investment base reasonably related to providing rail transportation service. (2) Value the investment base at original cost depreciated using straight line depreciation less the amount of the deferred tax reserve. (Unlike earlier CURE proposals, a substantial portion of the investment base would now be eliminated because of a perceived `double count'.) (3) Use the book (embedded) cost of debt in determining the cost of debt capital. (4) Determine the current cost of equity by considering such factors as bond ratings, fixed charge coverage, return on stockholders equity, debt to equity ratios, etc.

Paragraph (4), which now directs the Commission to annually determine which carriers are earning adequate revenues, is expanded to require the Commission to consider the first and second Long-Cannon factors, found at 10707a(e)(2)(C)(i) and (ii). This means that prices on non-captive traffic will be evaluated to see if they are yielding maximum revenues, and, where they are not, additional revenues will be assumed to have been earned. Railroads would be required to submit information allowing the public and the Commission to evaluate the carriers revenue requirement in light of the Long-Cannon factors and the public would be allowed to comment on the data supplied by the railroads.

Many of the points proposed by these revisions have been adopted by the Commission in its recent revision of revenue adequacy standards. In particular, the Commission now estimates the carrier rate base on the basis of depreciation accounting, with the subtraction of deferred tax accounts. Additional revisions were made to give more accurate recognition of "revenues, expenses, and investment base reasonably related to providing rail transportation." However, the bill goes beyond the Commission's revision in several regards which the Commission believes to be at odds with standard accounting and public utility practice, which depart from sound economics, and which further set up an internal contradiction with the remaining provisions of section 10704.

To begin, the bill would require the Commission to subtract assets from the rate base based on the "double count" controversy. GAO, in its report on revenue adequacy standards, calculated its version of the traditional utility method as the Commission does. And the Rail Accounting Principles Board, in its initial draft of proposed standards, also calculates the rail rate base without the "double count" subtraction. Thus, two independent analyses have rejected the bill's approach. The bill would like to use the lower investment base provided by the now discredited "betterment" accounting system and the higher earnings figures that come from depreciation accounting. Doing so would produce higher apparent rates of return, but only by ignoring the existence of real assets. Revenues would be sufficient to support and replace only a fraction of the industry's current facilities. Further, mixing asset levels derived from betterment accounting with earnings predicated on depreciation accounting is not consistent with the sponsors' stated desire for traditional public utility practice, but is contrary to such practice.

A second problem arises from the introduction of "Long-Cannon" issues into revenue adequacy. Long-Cannon essentially asks the question, can the railroads earn more from their traffic base than they currently do? If the answer is yes, the new bill would subtract such self-inflicted losses from the carriers' revenue needs in determining revenue adequacy.

If it is assumed that the rails are profit-maximizing firms, it may also be assumed that they presently take whatever margin is available to them on all their traffic, and that they do not willingly engage in loss operations. An independent evaluation of the entirety of a carrier's pricing strategy would require an enormous amount of information and post-hoc reasoning, where common sense would lead to the conclusion that the railroads are not undercharging any significant portion of their traffic. Consequently, the undertaking would impose substantial burdens without the prospect of significant benefit. While there is the real possibility of unsatisfactory profitability for thinly used line segments, so long as Federal policy requires government approval of abandonment and the payment of labor protection on abandoned segments, carriers should not be penalized for maintaining segments where immediate exit is forestalled by regulation. Furthermore, revenue adequacy determinations should not become a provocation hastening abandonment.

A third set of problems arise in the standards for determining the cost of capital. The bill requires that debt costs be calculated using incurred or embedded rates of interest, rather than the currently available interests costs. This issue is admittedly one in which there are valid arguments on both sides. GAO, in its report, found that current debt costs were the correct standard if a forward perspective is adopted. The Rail Accounting Principles Board concluded that the Commission's use of current costs is the correct standard. The bill would reject these independent assessments, seeking embedded debt costs as consistent with public utility practice. But on the issue of setting equity costs, the bill would force a departure from the Commission's existing practice of using "discounted cash flow" as the appraisal mechanism, despite the fact that discounted cash flow is the methodology preferred by the majority of state public utility commissions, and despite the fact that the ICC's estimated cost of equity is the same as generally found by utility Commissions. It is a fair inference that the private sector sponsors seek a lower target rate of return, and that this object provides a consistency of approach that would otherwise be lacking. But this objective is squarely at odds with the existing standards that now govern revenue adequacy and which would not be eradicated by the proposed amendments -- hence, the final problem that the bill poses, that of internal inconsistency in the resulting law.

Section 10704 presently defines adequate revenues as a flow of capital adequate to support prudent investment, repayment of debt, and raising of equity capital, and to cover the costs of inflation. The law continues that earnings should be able to attract and retain capital in amounts adequate to provide a sound transportation system. The law states that the Commission is to make an adequate and continuing effort to assist in the attainment of such revenues. These policy pronouncements are the product of the 1976 and 1980 reform laws, and reflect the judgment that insufficient concern for the economics of railroading was a principal factor in creating the dilapidation that characterized the previous decades.

The proposed amendments would invite a contrary interpretation of the Commission's mission. By artificially limiting the size of the investment base, by creating the opportunity to lower capital costs below those of the market, and by suggesting that revenues might be artificially inflated to reflect "better" pricing strategies, the bill signals a determination not to recognize capital requirements. Such a contrary message will inevitably create uncertain administration.

The Commission has not abused its present charge. Revenue adequacy standards used by the Commission have now been validated by two independent studies, and the Commission does not let revenue inadequacy stand as a bar to shipper relief where markets are abused. The issue is not considered in competitive access cases due to rules adopted through shipper/rail agreement. Reparations in all the recent maximum rate cases have been awarded despite the revenue inadequacy of the defendant carriers.

Section 8: Exemptive Authority

Section 10505 is amended to make the issuance of exemptions discretionary rather than mandatory. The sponsors are concerned that exemption from Commission regulation not be used when competitive forces do not exist to discipline railroad market power. Existing law is therefore amended by substituting "may exempt" for "shall exempt." A further change expands the group of protected persons from shippers to shippers and other persons. This provides explicit authority for consideration of the impact of an exemption on producers, consumers and labor. (These issues are not now foreclosed and are considered in exemption proceedings.) More critically, existing law is amended to prohibit approval of an exemption unless it is determined that the railroad does not have market dominance over the subject traffic. A determination of market dominance would not be required, however, if after appropriate notice no interested person objected to the exemption. Finally, a subsection is added providing that exempted rates and practices are subject to all other applicable Federal statutes, and that exempt rates and practices "shall not be considered as a matter subject to the regulation, supervision or other jurisdiction of the Commission." (This last phraseology is identical to that found in the Clayton Act proviso that limits the use of injunctive relief against regulated carriers.)

In its testimony presented last year on the predecessor S. 477 bill, the Commission indicated that the market dominance requirement would substantially limit the use of the exemption power, where its use has been found substantially beneficial to shipper and carriers alike. The thrust of this provision is directly contrary to the Staggers Act legislative history, in which the Commission is instructed to use the exemption power aggressively, and to supervise and backstop unforeseen problems through the explicit power to revoke exemptions where abuse arises. The addition this year of a provision indicating that other Federal laws apply in the presence of an exemption is similarly at potential odds with the revocation power. While the Commission has granted exemptions in which it has explicitly indicated that Federal statutes such as the antitrust laws will apply, the retention of discretion to require the revocation process is a valuable tool that permits industry-wide remedies to be fashioned and avoids unwarranted overlap in regulatory jurisdiction.

Section 9: Enhancement of Competition

The amendments to the IC Act contained in this section reflect the sponsors' desire to maximize intramodal rail competition. Shipper access to the services of more than one carrier is considered essential to the maintenance of railroad efficiency.

Section 10705 is expanded by inserting a new subsection to increase intramodal competition. Specifically railroads would be required to participate in at least one competitive joint rate with any and all carriers having an actual or practical interchange. Such a joint rate would be deemed competitive if the revenue to variable cost ratio is no higher than that realized by the carrier's single line rate or its division of an existing joint rate.

Section 11103 is amended to require mandatory use of terminal facilities and reciprocal switching if it is practical and necessary for the provision of alternative competitive rail service. In determining whether use of terminal facilities or reciprocal switching should be provided the Commission shall not consider the carrier's revenue adequacy or the existence of competition other than intramodal competition. In effect these amendments require the imposition of reciprocal switching and/or use of terminal facilities in all single carrier markets.

The Commission presented testimony last year outlining its objections to similar provisions contained in S. 477. Rather than reiterate these objections at length, it is perhaps more productive to focus on the fact that these "enhancement of competition" provisions in fact introduce a large dose of reregulation into deregulated and competitively functioning markets. Unlike the Staggers Act revisions to reciprocal switching, and unlike the Commission policies adopted in Ex Parte 445 (Sub-No-1), S. 676 permits mandatory interference in private arrangements without any regard to the existence of effective competition. Sharing of terminals and trackage and involuntary switching are required without regard to effective intermodal options. Joint rates are mandated even in the face of pre-existing rail-to-rail competition. And in every instance, the level of compensation may be specified by statute or fixed by administrative interpretation. Virtually one hundred percent of the rail base is thus reregulated with respect to access, despite the widespread recognition (acknowledged by many reform sponsors) that captivity problems are limited to a small portion of the shipping community. S. 676 proposes a major change in National policy without any indication of a widespread access problem, and without consideration of the unavoidable impact on investor willingness to sustain rail plant in the face of uncertainty over beneficial ownership.

Section 10: Abandonment Procedure

S. 676 proposes four amendments to existing abandonment rules. It would prohibit the refiling of a denied abandonment within one year of the denial. It would require the use of "line-specific" data in calculating profitability. It would require a local hearing on request in contested cases. Finally, it would prohibit the consideration of losses that arise from light density surcharges.

The first three provisions are the same as found in S. 477 last year. The Commission's testimony stated support for the idea that refiling should be deferred for one year where an on-the-merits denial has been issued. As to hearings and line-specific data, the Commission presently has the discretion to make use of both, and does so where the record will be materially enhanced without undue cost or delay. Use of line-specific data is infrequent however, as it may not be available without substantial expense, and its production may impose additional expense on complainants as well. Discussion of these matters is found at pages 23 through 26 of last year's testimony.

While the introductory language of S. 676 speaks of four "procedural" changes in abandonment rules, strictly speaking the fourth amendment, new this year, is not procedural, but substantive. It changes the standard by which abandonments are to be decided by eliminating any consideration of negative results from light density surcharges. Staggers provided the flexibility to surcharge light density lines to insure that they covered their costs. The proposed amendment would, in essence, ignore the results of prices increases unless they favored shippers. It is seemingly inconsistent with the Staggers Act goal of a self-sustaining rail system.

Section 11: State Authority

The sponsors' intent in amending Section 11501 is to streamline the procedures respecting State jurisdiction over intrastate rail transportation. The goal of the existing law is said to remain unchanged -- a State exercising jurisdiction over intrastate rail transportation must do so consistent with Federal law. The existing law is amended to eliminate the need for a state to have its standards and procedures for regulating intrastate rail transportation approved by the Commission. Rather it allows parties to have individual state rulings reviewed by the Commission to ensure consistency with Federal law. The Commission's scope of review is the same as that of an appellate court reviewing the decision of an administrative agency.

This is the same provision as that found in S. 477. The Commission testified last year that the state certification program is virtually complete, and that very few petitions for review are being filed. Consequently, there is little need for "streamlining" or other procedural reform. Further, the

Commission indicated that the proposed revisions of S. 477 were not mere procedures, but were likely to return the industry to pre-Staggers conditions of conflicting state and Federal regulation.

At present, states must regulate exclusively in accordance with the IC Act, and the Commission's review function is plenary. By changing the standard from exclusive accordance to consistency, room for conflicting outcomes is created. This is enhanced by limiting the Commission's appeal function to that of a reviewing circuit court where, theoretically, deference must be given to the state agency's interpretation of Federal law. Under long-standing Federal precedent, reviewing courts are to refrain from substituting their judgment for that of the expert agency whose orders are under review. Adherence to this tradition would create the potential for different outcomes in different states that could nonetheless withstand challenge at the Federal level. This problem is exacerbated by the fact that the Commission's power on appeal would be limited to remand without the authority to direct any particular outcome.

SEPARATE EXPRESSIONS

Vice Chairman Paul H. Lamboley commenting:

I concur in the issuance of the proposed testimonial statement to the extent such testimony is consistent with my voting positions and/or separate opinions in cases involving the subjects and issues addressed.

Commissioner J. J. Simmons III commenting:

Many provisions of S. 676 are intended to address legitimate concerns by members of Congress and of the public over this Commission's implementation of the Staggers Act. I cannot join in the unduly negative analysis of this legislation submitted by the majority. Rather, I am taking this opportunity to identify certain areas where, in my view, Congressional action might be especially appropriate.

Abandonment decisions made by the Commission often give inadequate consideration to local economic concerns and to national defense and energy development policies. Hearings held in localities affected by a proposed abandonment could increase the Commission's awareness of these matters. The majority notes that we already have the discretion to hold hearings as needed, but only two hearings were held in FY 1986, and only one hearing has taken place to date in FY 1987. These figures suggest that a conscious policy of denying requests for local hearings on abandonment applications is currently being followed. Congressional intervention may be necessary to remedy this situation.

Proposed changes in S. 676 to the Commission's exemption authority are directed at perceived abuses in past employment of this authority. Adoption of these changes would appear to prevent the resurrection of ill-conceived proposals such as the recent attempt to exempt export coal shipments from all economic regulation. The requirement for a finding of no market dominance before an exemption could be made would counteract the tendency of the Commission in some exemption proceedings to focus exclusively on the "big picture" and thus to ignore the impact on individual shippers or consumers. Whether the provisions in S. 676 relating to exemptions go too far in limiting the Commission's discretion can best be determined in the course of hearings and debate.

With regard to revenue adequacy, our current standard continues to yield unrealistic results. Use of embedded debt in computing the current cost of capital would be an improvement over current practice. I have also previously indicated my interest in a multiple standard approach to revenue adequacy determinations. The provisions of S. 676 on enhancement of competition are clearly a response to the continued refusal of a majority of the Commission to grant competitive access in appropriate circumstances such as the Midtec proceeding. I believe correct application of existing statutory standards by the Commission would result in the enhancement of competition, but legislative action may also be necessary in this area.

These comments of course do not cover the full range of subjects embraced in S. 676. Nevertheless, they will serve to distinguish my position from those of my colleagues who feel that "business as usual" is the best course for the Commission at this time.

Interstate Commerce Commission
Washington, D.C. 20423

OFFICE OF THE CHAIRMAN

July 24, 1987

Honorable Ernest F. Hollings
Chairman
Committee on Commerce, Science,
  and Transportation
United States Senate
Washington, DC 20510

Dear Chairman Hollings:

Enclosed are responses by the Interstate Commerce Commission to follow-up questions for the Surface Transportation Subcommittee's Staggers Rail Act oversight hearings on June 9, 17, and 24.

The opportunity to testify before the Subcommittee, and to provide additional written materials for the hearing record, is appreciated by the Commission.

Sincerely,

Heather J. Gradison

Heather J. Gradison
Chairman

Enclosure

QUESTIONS FROM SENATOR HOLLINGS

1. Your testimony notes a pattern of decline in rail rates since the passage of the Staggers Act. Yet, you also state that for coal, the benefits took longer to occur. To what do you attribute this difference?

This is most likely the result of several contributing factors. First, much of the rate reductions for other commodities have been made possible by changes to more efficient ways of moving the traffic (for example, unit trains or multicar shipments). These changes were made possible partly because of the rate flexibility afforded by the Staggers Act. But some coal traffic was already moving by unit train, even before 1980. So there has not been as much room for further efficiency gains in coal traffic.

Also, Eastern coal's rate patterns were much like those for other commodities. The main difference was for Western coal. Western coal shipments tend to be very long hauls and fairly new movements. Longer movements have higher costs per ton and require higher rates. Newness of the traffic meant that competitive relationships (and rates) had not yet stabilized. Even for Western coal, rates in real terms began falling after 1983. The Commission played an active role in facilitating falling prices: approval of new entry into Powder River by the ICC (1981 and 1986) has been critical to development of competitive pricing for Western Coal. We expect the 1986 figures, when they become available, to show a sharp further drop in Western coal rates, because of competition in the Powder River Basin area.

HOLLINGS

2. You have justified the ICC's decisions not to impose labor protection in line sales to shortline and regional railroads based on the rationale that labor protection would kill these transactions, resulting in abandonments and a loss of service to shippers and a loss of jobs for rail workers. What about in those instances where there is no showing that a line being sold is unprofitable? Is there any basis for assuming in these instances that abandonments would occur were labor protection to be required?

While there have been many cases where line sales have included properties which would not be abandoned immediately in the absence of sale, these properties are typically associated with branch-line feeders that would not survive in continued Class I ownership. Maintaining, indeed increasing, rail service may thus depend on inducing a buyer to take the bad with the good, and this requires a purchase price that reflects only a capitalization of the prospects of the new line. Adding anticipated labor protection costs will defeat these sales, greatly enhancing the likelihood of decline in rail service and employment.

A separate statement by Vice Chairman Lamboley follows.

Vice Chairman Lamboley, commenting:

While I have joined in the Commission's efforts to encourage and assist developing short line railroads, I do, however, continue to question the Commission's general assumptions and policy against the imposition of labor protection in the formation of short line and regional replacement carriers under 49 U.S.C.

Section 10901. Please see my separate expressions in Ex Parte No. 392 (Sub-No. 1), Class Exemption for the Acquisition and Operation of Rail Lines Under 49 U.S.C. 10901, served January 15, 1986; Finance Docket No. 30764, Arkansas and Missouri Railroad Company, Et al. Exemption From 49 U.S.C. 10901, 11301, 11322, and 11343, served July 17, 1986; Finance Docket No. 30779, Rochester and Southern Railroad, Inc., and Genesee and Wyoming Industries, Inc. - Exemption From 49 U.S.C. 10901, 11301, and 11343, served July 18, 1986; Finance Docket No. 30628, Lackawanna County Railroad Authority, Inc. - Exemption from Regulation, served February 11, 1986.

HOLLINGS

3. Your prepared testimony expresses your belief that farmers have benefited from rail transportation contracts because contracts have resulted in higher prices being paid for grain. Please elaborate on this.

Railroads have made contracts in which they offer substantially lower rates in return for shippers' cooperation in reducing costs. This cooperation may take the form of larger shipments, more regular shipments, better advance planning of movements, faster loading and unloading, etc. Much of this involves use of unit trains originating from large grain elevators and moving over high density rail lines. Academic researchers have found that the "margins" between grain prices at major markets and prices actually received by farmers have fallen sharply (largely reflecting the lower rail transportation costs incurred by grain shippers). For example, L.O. Sorenson and M. H. Chow of Kansas State University have found that rail transportation costs have fallen by more than a third since 1981 (for Kansas wheat) even before adjustments are made to reflect inflation. Furthermore, they found that because of the highly competitive environment, tariff rates fell as well. Thus, farmers are being paid a higher percentage of the final market price for their grain with less going to the elevator operator and railroad "middlemen."

Also, on February 18, 1987, the Commission's Contract Rate Advisory Service submitted a report to Congress in response to Section 4051 of the Conrail Privatization Act. The report assessed the competitive impact of railroad transportation contracts on grain shippers. One of the major findings in the report was that, on balance, farmers realized higher prices for grain because of contracts. This finding was based on the response of both small and large grain shippers. Also, all of the regional farmer cooperatives which filed responses reported increased prices to farmers because of contracts. These cooperatives represented 1,614 farmer owned country elevator members.

Additionally, as part of the report, State agricultural consultants surveyed 1,810 grain elevators in the major grain producing States of Illinois, Indiana, Iowa, Kansas, Montana, Nebraska, North Dakota, Minnesota, South Dakota, Texas, Washington, and Oregon to determine the effect of contracts on farmer prices. The survey results show 46 percent of elevators reported higher prices to farmers, 19 percent reported lower prices, and 35 percent reported no change.

4. Please elaborate on your views on the role of disclosure with regard to grain contracts.

Prior to passage of the Conrail bill, the Commission was poised to adopt revised contract disclosure rules for grain (as well as other commodities). Before us for consideration was a joint proposal negotiated by the Association of American Railroads and the National Grain and Feed Association. In its deliberations, the Commission was attempting to balance the somewhat conflicting statutory goals of confidentiality and release of "essential" information. For grain shipments, this was fairly controversial -- pitting grain shippers seeking more information against those desiring confidentiality.

The Conrail bill preempted this debate by requiring public notice of, most notably, the shipper's name, and specific locations for grain contracts. While certain parties still claim that the rate itself should be disclosed, it is the Commission's view, and Congress agreed, that the rate should not be disclosed in the contract summary. Other parties are claiming, in their comments to the interim rules for grain, that the rules disclose too much in the public summary. The matter is now under consideration and it would be inappropriate to comment further. As mentioned in Chairman Gradison's testimony, it is too soon to tell whether the increased disclosure mandated by the new legislation and by our interim rules is adversely affecting the extent of grain contracting.

HOLLINGS

5. Please comment further regarding your views on procedures that either are or may be put in place to benefit or assist small shippers in proceedings before the ICC.

The adjudicative process at the ICC (or any other agency) does not lend itself to simple or easy procedures that would treat smaller claimants substantially differently from large ones. Due process, judicial review, and the inherently complex issues that are presented under the Interstate Commerce Act have always required a sizeable commitment from parties -- shipper or carrier -- who decide to pursue relief before the agency. The Staggers Act had no effect on this. The number of cases filed by small entities has not changed to any measurable degree.

Through the years, the Commission through all its regional and headquarters offices has always held itself out to answer questions about ICC practices, procedures, and substantive law through, among other things, answering letters and phone inquiries from shippers or their counsel. The Office of Public Assistance is also available on any question, and filing fees are waived for good cause.

Over the past few years, we have revised a number of our rules to lighten the burden on shippers generally. For example, our market dominance rules now place the burden of proof on carriers as to the more difficult aspects of the analysis, our competitive access rules provide for suspension of joint rate cancellations upon a very minimal showing, and our interim contract rules simplify and lessen evidentiary requirements for potential shipper protestants seeking contract disclosure.

In Ex Parte No. 347 (Sub-No. 2), Rate Guidelines -- Non-Coal Proceedings, the Commission has proposed to move even further towards making relief more accessible. There, we are seeking comment on simplified rate reasonableness standards for rail captive shippers of small shipments of all commodities.

6. Federal Railroad Administrator John Riley has proposed that small shippers, particularly those who are unfamiliar with the regulatory process, should receive special help from the ICC's Office of Public Assistance in preparing their cases. Please comment on this, if you can.

The Office of Public Assistance (OPA) routinely responds to inquiries from shippers, carriers and the general public, directed almost entirely to assisting those unfamiliar with the regulatory process in dealing with Commission matters. Where rail abandonment applications have been set for oral hearings, OPA assists affected shippers, and state and local officials in preparing testimony and testifying before Administrative Law Judges to insure that all public interest aspects of each particular case are fully developed in the record set before the Commission for its decision. To facilitate this process, the Office publishes a rail abandonment booklet entitled A Guide For Public Participation in Rail Abandonment Cases Under The Interstate Commerce Act. The booklet, which has been widely distributed, helps shippers gain a general understanding of the Commission's rail abandonment standards and procedures.

Shippers sometimes are interested in purchasing and/or operating a railroad or in taking other actions to initiate or preserve service. OPA publishes another booklet, So You Want To Start A Small Railroad, which provides information on ICC procedures for obtaining approval to operate a railroad and to make offers of financial assistance for purchasing or subsidizing lines proposed to be discontinued or abandoned. The OPA staff briefs shippers on the options for entering the railroad business, the practical problems to be considered, and how to obtain financial aid.

In addition, the Commission currently has under study two proposals with respect to the role of OPA in assisting small shippers. One of these, in the area of rail abandonments, would follow up on a Draft Proposed Report prepared by the staff of the U.S. General Accounting Office in the Spring of 1987, Rail Abandonments: Abandonment Activity and Shipper Views on Rail Service Loss. The proposal would have OPA more formally participate in helping shippers and state and local government officials prepare and file their petition and argument to have cases set for oral hearings.

The other proposal for OPA to assist small shippers deals with certain rail cases. The Commission instituted Ex Parte No. 347 (Sub-No. 2), Rate Guidelines -- Non-Coal Proceedings, to develop simplified alternative procedures in captive rate cases where small amounts of traffic are involved, thereby allowing small shippers to avoid the considerable expense to prepare and present a case under Constrained Market Pricing (CMP) promulgated in Ex Parte 347 (Sub-No. 1), Coal Rate Guidelines, Nationwide, 1 I.C.C. 2d 520 (1985), aff'd sub nom. Consolidated Rail Corp. v. United States, Nos. 81-3080, et al. (3rd Cir. February 24, 1987). Shipper success in hearings before the Commission in CMP cases has given them new leverage in settlement negotiations with railroads. The Commission wants to do for the small shipper what Coal Rate Guidelines has done for the large coal shipper. In Non-Coal Guidelines, the Commission raised the prospect of aiding small shippers in their rail rate complaints through services provided by OPA.

HOLLINGS

7. If the Consumer Rail Equity Act were enacted, how do you feel it would affect the workload of the ICC, as well as the handling of rate cases pending before the Commission?

Passage of the Consumer Rail Equity Act would have adverse effects on our workload and on the timeliness of decisions -- both in the short term and the long term.

Immediately upon enactment, all staff work on pending cases would be halted. To the extent relief for the future was sought, it could be necessary to reopen the market dominance portion of all cases to allow defendant carriers to refocus their evidence on the remaining statutory factors. Changes to the rate reasonableness standards certainly would require reopening if only to reflect the changed burden of proof. But other changes are proposed as well. The bill provides 360 days for the agency to adopt rules implementing certain substantive changes. This could delay cases considerably more than 1 year. Our ongoing efforts to resolve pending disputes (there are now fewer than two dozen) would have been for naught. This is especially troubling in view of the age of these cases.

In the long term, the changes will have very dramatic and adverse effects. The proposed changes to our market dominance analysis and the reversal of the burden of proof -- to name but two of the proposals -- can be expected to increase geometrically our rate case docket. Even prior to the 4R Act in 1976, our rate docket was quite small vis-a-vis the number of potential complaintants. While the 4R Act and the Staggers Act put new limits on our maximum rate jurisdiction, the number of cases filed did not change significantly if one excludes the 861 Section 229 "window" cases. Parties continued to resolve most of their disputes in the marketplace.

A reversal of the burden of proof, standing alone, would create incentives for litigation at levels never before seen. It is not simply a question of evidentiary burdens. Any pricing above the jurisdictional threshold would be, at best, difficult to defend. As the court stated in National Ass'n. of Recycling Ind. v. I.C.C., 585 F.2d 522, 533 (D.C. Cir. 1978),

> By reversing the burden of proof ... Congress accomplished more than a mere change in procedural format ... . [I]t erected an evidentiary presumption against the lawfulness of rate structures ... .

The magnitude of the impact would be further increased by the relaxation of the market dominance analysis.

HOLLINGS

8. You have testified that in 1986 only three rate cases were filed before the Commission and that none has been filed in 1987. You also testified that shipper complaints and protests against new rail rates numbered no more than two dozen. For the record, please distinguish between rate cases and complaints and the ways in which these are handled by the ICC.

There are two basic types of maximum rate cases -- those which are instituted before the rate becomes effective ("investigations") and those instituted after the challenged rate is effective ("complaints").

The former are prompted by "protests" to proposed rate changes. Protests can be filed by anyone. Yet, as our testimony noted, very few were filed in 1986. Because the after-the-fact complaint remedy is available, the Commission's authority to investigate proposed rate changes is discretionary. If the Commission investigates, it institutes a proceeding and directs the filing of evidence.

In the case of a complaint, the Commission accepts and processes every complaint filed. In 1986, only three were filed.

Once the cases are begun, there is no difference in the Commission's procedural handling of them.

QUESTIONS FROM SENATOR ROCKEFELLER

1. You testified on June 17th that rail profitability has risen modestly since 1981. Mr. Dempsey testified on June 9th, however, that rail profitability in 1986 was actually lower than in 1980. Please explain the difference.

The difference between Mr. Dempsey's and my testimony on rail profitability is largely a matter of perspective. My viewpoint of railroad profitability was broad based, including a comparison of financial performance during the five years leading up to the passage of the Staggers Act and the five years following enactment. Mr. Dempsey is correct in his observation that railroad return in 1986 was lower than the level recorded for 1980. However, viewed more broadly, rail returns since 1980 are generally higher and show modest improvement over those achieved in each of the years 1977 through 1980. Also, railroad earnings, relative to earnings for business generally, have shown improvement since enactment of the Staggers Rail Act.

Rockefeller

2. You testified that a new non-coal rate guidelines for small shippers "will make rate relief readily available for all shippers, regardless of their size." Why are these new guidelines available only to "non-coal small shippers"? What is the legal authority and policy justification for such a distinction?

The Commission did not propose the guidelines be available only to non-coal small shippers. Ex Parte No. 347 (Sub-No. 2), while it is titled "Non-Coal Proceedings," specifically proposes new, alternative standards for any case "where the cost of preparing and presenting [constrained market pricing] evidence is prohibitive." This can include coal cases. The notice specifically seeks comment on whether the coal rate guidelines should be limited to "unit train or otherwise large movements of coal."

3. You testified that "there is no defensible revenue adequacy standard that would produce a lot of revenue adequate railroads." Would such a test produce even one revenue adequate railroad? How are you sure of this result when you admitted in your revenue adequacy determination for 1985 that you did not have sufficient data to apply all the changes to your revenue adequacy test that you had adopted?

It is unlikely that a defensible revenue adequacy standard would produce even one revenue adequate carrier. The GAO, in a recent report for Representative Dingell examined four different methodologies intended to cover the whole range of alternatives being advocated: The ICC's approach (before the recent modifications), the traditional Public Utility Commission standard (embedded debt, etc.), and two more ad hoc standards it later rejected. The GAO concluded that no railroad was revenue adequate under any of the standards. Under three of the approaches, all the railroads were clearly revenue inadequate and under one of the rejected approaches no conclusions could be drawn.

The modifications adopted in Ex Parte No. 393 (Sub-No. 1), Standards for Railroad Revenue Adequacy, served December 31, 1986, represent a refinement to the existing standard; they do not represent a basic change in the standard itself. We do not yet have all of the data under these standards because the technical changes are currently in the rulemaking stage. However, given the wide margin between individual railroad ROI's and the cost of capital rate, it is unlikely that the modifications would have a significant effect on the 1985 revenue adequacy findings even if they were adopted.

Rockefeller

4. You testified that the ICC has ordered rate reparations in four out of five cases where final rate determinations have been made. Please give me the specifics on each case including style of case and docket number; date the complaint was filed; the amount of reparations sought in the complaint; the reparations granted; the standard that formed the basis for the reparations; the "stand alone cost" rate showing made by the railroad; and whether the case is now being appealed and, if so, by whom and in which Federal court.

The attached chart provides the requested information.

RATE REPARATIONS
SAN ANTONIO, OMAHA, AP&L, AND RADIOACTIVE MATERIALS CASES

DOCKET NUMBER	NAME AND STYLE	DATE FILED	REPARATIONS SOUGHT	REPARATIONS GRANTED	BASIS FOR REPARATIONS	RAILROAD STAND-ALONE COST	CURRENT STATUS
36719	Ark. Power & Light Co., et al. v. Burlington N. Inc. (complaint) (Redfield)	9/26/77	Redfield - ranged from approximately $42.9 million - $49.3 million, based on different methods of calculation. Other suggested amounts submitted under seal.	Redfield - $238,017.00 plus interest.	Ex Parte No. 347 (Sub-No. 1)	Redfield - Introduced by quarter. E.g., for one quarter $22.85.	Court cases instituted on or about 7/9/87: 1) Burlington Northern (87-1321) U.S. Court of Appeals for Dist. of Columbia Circuit (pending). 2) Missouri Pacific (87-1323) U.S. Court of Appeals for Dist. of Columbia Circuit (pending). 3) Arkansas Power & Light Co. (87-4504) U.S. Court of Appeals for the 5th Circuit (pending).
(embraces 37456,	Ark. Power & Light Co., et al. v. Burlington N. Inc. (complaint) (Redfield)	6/12/80					
39082,	Ark. Power & Light Co., et al. v. Burlington N. Inc. (complaint) (Newark)	2/2/83	Newark - $12,277,628.	Newark - Rates found not shown unreasonable - no reparations ordered.	Ex Parte No. 347 (Sub-No. 1)	Newark - Introduced by quarter. E.g., for one quarter, $22.85.	
and 39668)	Ark. Power & Light Co., et al. v. Burlington N. Inc. (complaint) (Kansas City)	2/10/84	Kansas City - $22,429,901.	Kansas City - $21,862,525.00 plus interest.	Ex Parte No. 347 (Sub-No. 1)	Kansas City - Introduced by quarter. E.g., for one quarter, $14.50.	

DOCKET NUMBER	NAME AND STYLE	DATE FILED	REPARATIONS SOUGHT	REPARATIONS GRANTED	BASIS FOR REPARATIONS	RAILROAD VARIABLE COST	CURRENT STATUS
37891S	Commonwealth Edison Co., et al. v. Aberdeen & Rockfish R. Co. et al. (complaint)	3/25/81	Complainants sought an extension to rest of the country of the rates prescribed for East in Radioactive III*. Government also sought joint rates to and from the East and an unspecified amount of reparations from eastern carriers for past shipments.	Government awarded reparations of the difference between charges paid and charges established by extension of the rate ceilings prescibed in Radioactive III, ranging from 200.6 to 255.7% of restated variable cost plus interest. Actual amount will be calculated from statements due from complainants under 49 CFR 1132.2.	Assessment of rates based on unwarranted and excessive cost additives found to result in an unreasonable practice (avoidance of common carrier obligation with respect to radioactive commodities). R/VC ceilings from Radioactive III imposed.	Railroads sought cost additives for: (1) insurance expense; (2) potential interruption (where derailments result in regulatory delay but no indemnification); (3) a 35 mph speed restriction on governmental traffic; (4) special clearances; and (5) additional switching. [Average R/VC ratios without additives were: 911% for spent nuclear fuel, 806% for empty fuel casks and 501% for radioactive components.]	Court proceeding instituted on or about 7/24/86 by Union Pacific Railroad Company (No. 86-2096) before U.S. Court of Appeals for the Tenth Circuit but transferred to the U.S. Court of Appeals for the District of Columbia Circuit (pending).
37998S	General Electric Co., v. Aberdeen & Rockfish R. Co., et al. (complaint)	3/26/81					
38004S	Carolina Power & Light Co., et al. v. Aberdeen & Rockfish R. Co., et al. (complaint)	3/27/81					
38302S	U.S. Dept. of Energy and U.S. Dept. of Defense v. B&O R. (complaint)	3/27/81					
38376S	U.S. Dept of Energy and U.S. Dept of Defense v. Aberdeen & Rockfish R. Co., et al. (complaint)	3/27/81					

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*Trainload Rates on Radioactive Materials, East. R., 362 I.C.C. 756 (1980), aff'd sub nom. Consolidated Rail Corp., v. ICC, 646 F.2d 642 (D.C. Cir. 1981), cert. denied, 459 U.S. 1047 (1981), supplemented 364 I.C.C. 981 (1981).

DOCKET NUMBER	NAME AND STYLE	DATE FILED	REPARATIONS SOUGHT	REPARATIONS GRANTED	BASIS FOR REPARATIONS	RAILROAD STAND-ALONE COST	CURRENT STATUS
38783	Omaha Pub. Power Dist. v. Burlington N. R., Inc. (complaint.)	2/1/82 amended 6/27/84	Not specified.	$17,504,168.42 plus interest.	Ex Parte No. 347 (Sub-No. 1)	3rd Q. 1982 - $41.97 4th Q. 1984 - $41.97 1st Q. 1985 - $38.97 (engineering method), $34.13 (CMV method).	Court action instituted on or about 6/5/87 (No. 87-3391) before U.S. Court of Appeals for the Third Circuit by Burlington Northern (pending).
36180	San Antonio, Texas	1/20/83	Up to $78.9 million as of 2nd Q. 1984.	$40,065,267.00 10/1/80-3/31/84; and schedule set for new cost evidence on subsequent movements.	Reparations awarded to 162% revenue-to-variable cost standards of §203(c)(1)(A) of the Staggers Rail Act of 1980.	RR variable cost ranging from $11.11 (1st Q. 1980) to $17.68 (3rd Q. 1982).	Dismissed on 1/22/87 at request of complainant based on settlement (closed).

Rockefeller

5. Please give the name, status, and commodity involved in each of the remaining captive shipper rate complaint cases:

The attached chart provides the requested information.

STATUS OF PENDING RATE CASES
7/15/87

No.	Title	Commodity	Status
(1) No. 36114	Potomac Electric Power Co. v. Consolidated Rail Corporation, et al.	Coal	Decision served 12/11/86. Petition to reopen filed 1/20/87. CSX replied on 2/20/87. A decision is being prepared.
No. 36114 (Sub-No. 1)	Potomac Electric Power Co. v. Consolidated Rail Corporation, et al. (embraced in No. 36114)	Coal	See No. 36114.
(2) No. 37010	General Electric Company v. Delaware and Hudson Railway Company, et al.	Electric Generator Parts	Decision served 5/4/87, finding that the defendant railroad had market dominance. At complainant's request, the rate reasonableness phase of the case is being held in abeyance.
(3) No. 37038	Bituminous Coal, Hiawatha, UT to Moapa, NE	Coal	Settlement discussions and record building are continuing. A motion for discovery has been filed, and the parties have reached agreement on discovery relative to basic cost issues. A motion to compel on remaining issues has been filed, and is under consideration by the ALJ. A docket management conference was held 7/13/87.

No.	Title	Commodity	Status
(4) No. 37063	Increased Rates on Coal, L&N RR, October 31, 1978; Increased Rates on Coal, L&N RR, November 1978; Increased Rates on Coal, L&N RR, December 1978; Increased Rates on Coal, L&N RR, December 1978 - January 1979; Increased Rates on Coal, L&N RR; Increased Freight Rates and Charges, Nationwide--8 Percent	Coal	Held in abeyance at request of the parties, pending settlement negotiations. Decision served 5/12/86, dismissing some complaints, and imposing a status report requirement on the progress of negotiations. A status report was filed 5/9/87; negotiations are continuing with the sole remaining complainant, Dayton Power and Light. The Commission served a decision on 7/6/87, adopting a procedural schedule that will be effective if, by 8/5/87, settlement has not been reached and a motion for dismissal received.
No. 37063 (Sub-No. 1)	(embraced in No. 37063)	Coal	*See* No. 37063
No. 37063 (Sub-No. 2)		Coal	
No. 37063 (Sub-No. 3)		Coal	
No. 37063 (Sub-No. 4)		Coal	

No.	Title	Commodity	Status
No. 37409	Aggregate Volume Rate on Coal, Acco, UT to Moapa, NE (embraced in No. 37038)	Coal	See No. 37038.
(5) No. 37437	Arizona Electric Power Cooperative, Inc. v. Atchison, Topeka & Santa Fe Railway Co., et al.	Coal	Decision served 5/22/87 addressing market dominance and cost issues. Decision applying coal rate guidelines to past movements completed and under review. Record regarding market dominance for the future reopened for 90 days. Procedural schedule set. Numerous motions pending. Complainant now seeks to hold the proceeding in abeyance by petition filed 7/10/87, based on a settlement having been reached by the parties.
(6) No. 37477	General Electric Company v. Consolidated Rail Corporation, et al.	Electric Generator Parts	Decision served 5/4/87, finding that the defendant railroads had market dominance. At complainant's request, the rate reasonableness phase of the case is being held in abeyance.
(7) No. 37478	Amstar Corporation v. The Atchison, Topeka and Santa Fe Railway Company, et al.	Corn syrup	Decision served 4/10/86, directing the filing of additional evidence on market dominance. Evidence received and a decision is being prepared.

No.	Title	Commodity	Status
(8) No. 37626	Consolidated Papers, Inc., et al. v. Chicago and North Western Transportation Company, et al.	Pulpwood and Wood Chips	Procedural schedule established by decision served 12/11/86. Evidence received. Complainants have filed a motion for a procedural schedule. A decision is being prepared.
(9) No. 37809	McCarty Farms, Inc., et al. v. Burlington Northern, Inc.	Wheat	Decision served 5/27/87 finding market dominance. The Commission also made tentative rate reasonableness findings and set a timetable for the filing of additional evidence with respect to those findings. Comments were due 7/13/87 and replies are due 7/28/87. On 7/1/87 the Commission denied a request by the defendant railroad to vacate the tentative rate reasonableness findings and to postpone the schedule for the filing of comments and replies.
No. 37809 (Sub-No. 1)	McCarty Farms, Inc. v. Burlington Northern Railroad Company (embraced in No. 37809)	Barley	See No. 37809.
No. 37815S**	Montana Department of Agriculture, et al. v. Burlington Northern, Inc. (embraced in No. 37809)	Wheat and Barley	See No. 37809.

**The "S" designates a complaint filed under the Staggers Act section 229 savings provision.

No.	Title	Commodity	Status
(10) No. 37854S	Consumers Power Co. v. Norfolk & Western Railway Co.	Coal	In negotiations. A docket management conference was held 2/9/87. A status report of the negotiations was filed 5/22/87. The Commission served a decision on 7/6/87 adopting a procedural schedule to be effective if, by 8/5/87, settlement has not been reached and a motion for dismissal filed.
(11) No. 37925S	Department of Defense v. Seaboard System Railroad	Munitions	In negotiations. A status report was filed on 5/8/87. Complainant filed a counter offer on 6/8/87. By decision served 6/25/87, the Commission has ordered the defendant railroad to make a timely response to complainant's counter offer. The 6/25/87 decision also sets a procedural schedule. Opening statements are to be filed on by 9/18/87; replies by 11/2/87; and rebuttal by 12/2/87. Oral hearing, if required, is set for 12/8/87.
(12) No. 37931S	Metropolitan Edison Co. v. Consolidated Rail Corp., et al.	Coal	In record building. Decision served 7/6/87, addressing interlocutory appeal to discovery rulings of the Chief Administrative Law Judge. Procedural schedule reestablished. Opening statements due 8/3/87; cross examination 8/24/87; repolies due 9/25/87; rebuttal due 10/23/87; cross examination 11/11/87.

No.	Title	Commodity	Status
(13) No. 38025S	Dayton Power & Light v. Louisville & Nashville R.R. Co.	Coal	Decision served 7/19/87, finding market dominance. The rate reasonableness aspect of the case has been held in abeyance at the request of the parties, pending negotiations. A status report was filed 5/9/87, and a settlement offer has been submitted to the complainant by the defendant railroad. By decision served 7/6/87, the Commission adopted a procedural schedule that will be effective if, by 8/5/87, a settlement has not been reached and a motion for dismissal filed.
(14) No. 38056S	Indianapolis Power & Light Co. v. Consolidated Rail Corp., et al.	Coal	In record building. Complaint has been dismissed (following settlement) except for rates on coal over Conrail. Opening statements are due 8/10/87. Conrail filed petition to reopen market dominance issue on 6/29/87. Will be resolved following receipt of reply.
(15) No. 38125S	General Electric Company v. The Baltimore and Ohio Railroad Company, et al.	Methyl Chloride	Decision served 3/25/87 finding market dominance. The rate reasonableness aspect of the case is being held in abeyance at the complainant's request.

No.	Title	Commodity	Status
(16) No. 38188S	Westinghouse Electric Corporation v. The Alton & Southern Railway Company, et al.	Heavy Electrical Machinery	Pending on appeal of ALJ decision finding market dominance and rates not shown to be unreasonable. A decision is being prepared.
(17) No. 38238S	McGraw Edison Company v. The Alton & Southern Railway Company, et al.	Electric Transformers	Decision served 4/25/86 finding market dominance. At complainant's request, the rate reasonableness aspect of the case is being held in abeyance.
(18) No. 38239S	Amstar Corporation v. The Alabama Great Southern Railroad, et al.	Sugar	Pending on voluntary remand of employee board decision finding no market dominance. A decision is being prepared.
(19) No. 38301S	Coal Trading Corporation, et al. v. The Baltimore & Ohio RR Co., et al.	Coal	In record building. Opening statements were filed 12/22/86; replies were filed 5/15/87; and rebuttal statements are due 9/14/87. Oral hearing, if required, will be held 9/28/87.
(20) No. 38301S (Sub-No. 1)	Westmoreland Coal Sales Co. v. Denver & Rio Grande Western RR Co.	Coal	Record building and negotiations in progress. Opening statements due 7/10/87. Reply evidence and argument is due 10/20/87.

No.	Title	Commodity	Status
(21) No. 38412	Allied Chemical Corp., et al. v. Ann Arbor RR, et al.	Sodium Carbonate	Remanded to the Commission 5/1/87, by the U.S. Court ofAppeals, District of Columbia Circuit. Reopened on market dominance issue by Commission decision served 6/10/87. Procedural schedule set. Complainants' request for a 90-day postponement for settlement negotiations granted. Status report due 9/10/87.
(22) No. 40073	South-West Railroad Car Parts v. Missouri Pacific Railroad Co.	Obsolete railroad cars	Decision served 7/10/87 denying railroads' appeal and granting shipper's appeal of ALJ decision. 7/10/87 decision finds market dominance and makes tentative findings on rate reasonableness. Comments are due 8/24/87; replies due 9/8/87.
(23) No. 40107	General Electric Co. v. The Atchison, Topeka & Santa Fe Railway Co., et al.	Electric Transformers	In record building. Docket management conference held 2/3/87. Partial settlement reached. An amended complaint has been filed. Discovery in progress.

Rockefeller

6. Please give me the specifics on the dozen market dominance decisions you have made in the last eighteen months, including the name of the case, the date the complaint was filed, the defendant railroad, the decision of the ICC, including the ICC's determination of product and geographic competition.

The attached chart contains the requested information regarding the 14 decisions since January 1, 1986, addressing market dominance.

MARKET DOMINANCE FINDINGS SINCE 1/1/86

No.	Title	Filed	Defendant(s)	MD	Prod/Geo	Embraced Cases
38783	Omaha Pub. Pwr. Dist. v. Burlington N. R., Inc.	2/1/82	BN	Present	No	
36719	Arkansas Pwr. & Lt. Co. v. Burlington N., Inc.	9/26/77	BN, MP	Present	No	Nos. 37456, 39082, 39668
37853S	Consumers Pwr. Co. v. Missouri Pac. RR Co.	3/26/81	ICG, MP, Belt Ry. Co. of Chi., L&N	Present	No	
37010	General Elec. Co. v. Delaware & H. Ry. Co.	8/22/78	D&H, CR, N&W, MP, ICG	Present	No	
37477	General Elec. Co. v. Consolidated R. Corp.	7/16/80	CR, ATSF, SP	Present	No	
38446	General Elec. Co. v. Chesapeake & O. Ry. Co.	4/15/81	CR, CP, D&H, Maine C., Napierville J., N&W, Portland T., Southern; 38636 - C&O, CN, CP, CR, D&H, Elgin, J. & E., GTW, ICG, Maine C., MP, Napierville J., N&W, Southern	Present	No	No. 38636
37891S	Commonwealth Edison Co. v. Aberdeen & Rockfish RR Co.	3/25/81	(attached)	Present	No	Nos. 37998, 38004, 38004, 38302, 38376
38084S	Int'l. Minerals & Chem. Co. v. Burlington N.	3/27/81	BN, ICG, SCL	Reopened for more evidence	Undecided	

No.	Title	Filed	Defendant(s)	MD	Prod/Geo	Embraced Cases
38088S	Arizona Pub. Serv. Co. v. The Atchison, T. & S. F. Ry. Co.	3/27/81	ATSF, BN, St. Louis SW, SP	Absent	Yes	
38125S	General Elec. Co. v. The Baltimore & O. RR Co.	3/27/81	B&O, D&H, ICG, MP, N&W	Present	No	
38238S	McGraw Edison v. The Alton & Southern Ry. Co.	3/27/81	Alton & Sou., ATSF, B&O, BN, Carrollton RR, C&O, CNW, RI, Conrail, Elgin, J&E Ry. Co., Fairport, P&E Ry. Co., Fort Worth & D. Ry. Co., ICG, IHB, KCS, MKT, MP, N&W SCL, SLSF, Soo, Southern, SP, St. Louis SW, Toledo, P. & W. RR Co., and UP	Present	No	
37809	McCarty Farms, Inc. v. Burlington N., Inc.	3/27/81	BN	Present	No	Nos. 37809 Sub 1 and 37815S
37437	Arizona Elec. Pwr. Coop., Inc. v. The Atchison, T. & S.F. Ry. Co.	5/5/80	ATSF, SP	Present	No	
40073	South-West RR Car Parts v. Missouri Pac. R. Co.	12/12/85	MP	Present	No	

7. You testified "we promised to come up with new, fast and less expensive rate reasonableness rules for a small shipper, and we did." Please identify those rules and indicate whether they are final rules.

The proposed rules are identified as Ex Parte No. 347 (Sub-No. 2), Rate Guidelines, Non Coal Proceedings, served April 8, 1987. They are proposed rules. Tentative application of the rules has been made in two maximum rate proceedings.

Rockefeller

8. You indicate that the C.U.R.E. bill "contains competitive access concepts that in the words of a report court decision, would work a radical restructuring of the rail industry." Please provide the court decision that made that judgment and indicate exactly the provisions of the C.U.R.E. bill that were the subject of this decision.

See, *Baltimore Gas and Electric Co.* v. *U.S.A.*, (D.C. Cir. Nos. 85-1761, 85-1845, April 21, 1987.) Slip opinion at 15. Section 9 of S. 676 would grant the mandatory access sought and denied in this case -- in particular, mandatory trackage rights.

Rockefeller

9. You made a comment that the C.U.R.E. bill would change the government's role from "backstop to umpire, once again, in on every play." Does this statement go to the captive shipper provisions of the C.U.R.E. bill.? If so, please explain this conclusion.

Under the Staggers Act the ICC has been retained as a backstop, a presence necessary to prevent abuses in those (few) instances when shippers are not adequately protected by market forces. The proposed C.U.R.E. legislation reverses the Staggers Act concept that rates should be regulated only in the absence of effective competition. Unnecessary government interference in efficient and competitive market interactions would be required by the following provisions of the C.U.R.E. bill.

First, Section 3 (Market Dominance) of S. 676 would amend the definition of market dominance. Beginning with the 4R Act, the regulation of rail rates has been limited to instances where there is a lack of effective competition that can be relied on to obviate the need for Federal supervision. S. 676 would define effective competition as point-to-point competition from other carriers for the same commodity, thus eliminating product and geographic competition from consideration in such proceedings. These concepts are extremely important gatekeepers. Shippers served by alternative carriers and modes with differing sources or destinations now use self-help measures to examine their market alternatives and find leverage. Excessive reliance on regulatory litigation has been diminished sharply. Marketplace solutions increase efficiency and help carriers, shippers, and the public alike. If these gatekeeping disincentives to litigation are removed, and particularly, if the removal is coupled with new ratemaking standards designed to reduce the level of allowable rates, a return to needless litigation and over-regulation is almost certain.

Section 4 of S. 676, Rate Reasonableness, places the burden of proof in all rate investigations on the railroads. It also changes the standard for judging rates to reduce the emphasis on revenue adequacy, and to call into question the need for rates above the jurisdictional threshold. These changes will invite and encourage regulation where market-based alternatives are now relied on.

Finally, Section 9 of S. 676, the "enhancement of competition" provisions, introduce a large dose of reregulation into deregulated and competitively functioning markets. Unlike the Staggers Act revisions to reciprocal switching, and unlike the Commission policies adopted in Ex Parte 445 (Sub-No. 1), S. 676 permits mandatory interference in private arrangements without any regard to the existence of effective competition.

Sharing of terminals and trackage and involuntary switching are required without regard to effective intermodal options. Joint rates are mandated even in the face of pre-existing rail-to-rail competition. And in every instance, the level of compensation may be specified by statute or fixed by administrative interpretation. Virtually one hundred percent of the rail base is thus potentially subject to reregulation despite the widespread recognition (acknowledged by many reform sponsors) that captivity problems are limited to a small portion of the shipping community.

Rockefeller

10. You testified that "legislation at this time would be difficult for the industry to absorb, and frankly, irresponsible on the part of Congress." Your responsibilities run not only to the rail industry, but to captive shippers as well. Why would it be irresponsible for us to act legislatively and would the legislation be hard for captive shippers to absorb?

The question presumes an inherent antipathy between the interests of captive shippers and their railroads. This has been shown not to be the case by the post-Staggers results. Captive shippers are today better served at lower prices precisely because the rail industry has ben permitted greater freedom from regulation. Legislation that is harmful to the rail sector will have an identical impact on the captive shipper population, the only issue being one of timing. Absent subsidy from the government, a return to regulation will not benefit any shipper group.

Rockefeller

11. Mrs. Gradison, if the revenue adequacy determination of the ICC is so important a measure of railroad health, why do no railroad industry filings at the SEC, including their annual reports and the recent Conrail stock sale prospectus, include the ICC's calculated cost of capital and the ICC's determination that the railroad in question is "revenue inadequate"?

This is a matter within the expertise of the Securities and Exchange Commission. Any assessment by the ICC of the practices and requirements of the SEC would necessarily be highly speculative. Clearly that agency would be in the best position to explain its requirements.

Rockefeller

12. Mrs. Gradison, in your Santa-Fe-Southern Pacific merger dissent you referred to our nation's "financially sound" railroads. Please name those railroads you consider to be "financially sound." Also, please explain the difference between "financially sound," "profitable" and "revenue adequate."

A financially sound railroad is one that has little or no risk of insolvency because it is generating enough profits to pay its fixed charges and dividends. Because of the success of the Staggers Act none of the larger railroads are in any immediate danger of insolvency.

However, these railroads have not been found by the Commission to be revenue adequate because the magnitude or level of their profits, while sufficient in terms of covering interest and dividends, are not adequate to produce a rate of return on net investment equal to or greater than the cost of capital. This means that profits are below the level considered necessary to attract and maintain new capital sufficient to allow for the replacement of assets and expansion of operations into new rail markets. Because of this fact, we have seen a general shrinkage of the railroad industry that has not been fully arrested.

Rockefeller

13. You say the sale price of Conrail was half of its net book value and that means that Conrail is revenue inadequate. Another interpretation would be that the market, including many of the major New York investment houses, value the assets of Conrail at half their book value. Doesn't this mean that the net asset base of Conrail for ICC revenue adequacy purposes, should be $1.9 billion rather than the net book value of $3.5 billion?

No, it does not. The investor's interest in Conrail's net asset base is $3.5 billion dollars. That is the net investment base that Conrail must ultimately replace. If Conrail's expected earnings and dividend yield could be expected to equal their cost of equity capital the market value of the stock would, approximate its book values. However, the investors obtained a collection of assets they were prohibited from selling; they face uncertain future earnings growth and uncertain dividend yields. Therefore, the value of the stock was discounted to reflect these uncertainties. Unless Conrail can earn its current cost of capital on this net asset base of $3.5 billion they will be unable to replace some or all of those assets. This is why Congress included a provision in the Conrail Privatization Act which prevents the ICC from revising Conrail's asset base.

This provision states the following: "For purposes of ICC and state regulation, the public offering and the subsequent value of consideration received shall not alter the value of Conrail's assets net of depreciation and shall not be used to alter the calculation of Conrail's stock, asset values, rate base, expenses, costs, returns, profits or revenues, or otherwise affect or be the basis for a change in the regulation of any railroad service, rate, or practice provided by Conrail, or any change in the financial reporting practice of Conrail."

Rockefeller

14. Mrs. Gradison, you said that "the formula (revenue adequacy) that we have today has been upheld by the GAO and the railroad accounting principles board." Please identify the relevant pages and quotations from the documents in which you assert the GAO and the railroad accounting principles board have upheld your new revenue adequacy test.

The GAO, in its October 1986 report titled "Railroad Revenues - Analysis of Alternative Methods to Measure Revenue Adequacy", concluded that ICC's then existing approach and a "traditional approach" favored by certain shippers have certain important similarities that could form an acceptable basis for measuring revenue adequacy (page 3 of the report). A detailed discussion of these two approaches and two other approaches which GAO claims have key weaknesses appears in Section 4 of the report, pages 69 to 126. No major railroad was found by GAO to be revenue adequate in 1984 using any of these approaches. Subsequent to the release of the GAO report, the ICC, in a decision served December 31, 1986, in Ex Parte No. 393 (Sub-No. 1), Standards for Railroad Revenue Adequacy, made certain major modifications in the calculation of its revenue adequacy standard which significantly reduces the differences between the ICC approach and the traditional approach described in the GAO report.

The Commission's revised revenue adequacy standards are virtually identical to those proposed by the RAPB, in its February 20, 1987 Exposure Draft titled "Railroad Accounting Principles". The RAPB recommends that railroad return on investment be determined using an original cost net investment base less the amount of deferred tax reserves (on a depreciation accounting basis). The Exposure Draft proposes that the target cost of capital rate be determined using the current cost of debt and equity capital and market value based capital structure mix for a sample of railroad holding companies. All of these RAPB proposals have been adopted by the Commission.

There are only minor differences between the Commission and the RAPB's proposals. First, in deciding which affiliate companies to include with the railroad for revenue adequacy calculation, the Commission has a slightly more restrictive definition that could exclude some companies/activities that would be included under the RAPB definition.

Second, the RAPB recommends that all transactions between the railroad entity and those parties outside the railroad entity be recorded at fair market value. This reflects RAPB's desire to eliminate any distorting effects that transactions with affiliates might have on a railroad's ROI. Rather than estimating fair market value, the Commission's staff periodically reviews the reasonableness of transactions between the railroads and their affiliates and, over the past several years, has found no instances of substantive abuse of the railroads by their affiliates.

Finally, the RAPB proposes that the Commission use the current cost of capital which it is now doing.

Rockefeller

15. You testified that you police the financial health of new short lines and regional railroads by investigating any such lines that appear to be shaky. How many of such rail lines have failed since 1980 and how many investigations of such lines have you implemented since 1980? Please give docket number and other relevant information on each case.

Since 1980, approximately 160 new short line and regional railroads have commenced operations. Only 12 new shortlines (formed after the Staggers Act) have completely abandoned operations. They are:

Docket No.	Railroad	State	Miles
AB-228	Chelatchie Prairie	Washington	29.5
(Rock Island)	Enid Central	Oklahoma	85.2
(Erie Lackawanna)	Fulton County	Indiana	15.0
(Switching Line)	Jersey Central Terminal	New Jersey	--
(Suspended Operations)	Marion County	South Carolina	6.3
(Rock Island)	No. Central Oklahoma	Oklahoma	51
AB-252(Subs 1 and 2)	Northern Missouri	Missouri, Iowa	104
(Penn Central)	Ontario Eastern	New York	19
AB-237	Pend Oreille Valley	Washington	61
AB-229	Prairie Central	Illinois	136
(Milwaukee Road)	Raccoon River	Iowa	10
(Milwaukee Road)	Wisconsin Western	Wisconsin	115

These lines ceased operations primarily because of lack of traffic and/or heavy maintenance and operating costs. As noted above, several of these short lines were formed in an attempt to continue service on deteriorated lines of bankrupt carriers (Rock Island, Milwaukee Road, Penn Central, & Erie Lackawanna), and operated under various ICC emergency service orders. All but two of the above carriers operated over lines which were to be abandoned by the previous owners. Detailed histories of the remaining two lines are not available, however, it is known that the Chelatchie Prairie acquired the lines of the former Longview, Portland, & Northern in 1981; and the Jersey Central Terminal Co. operated a small switching line in Linden, NJ.

Rockefeller

16. How many final decisions of the ICC have granted captive shippers rate relief under the generally applicable rate reasonableness standards of the ICC? Please state the name, docket number, date complaint was filed, date the case was decided and rate reasonableness standard used in each case.

There are no "generally applicable rate reasonableness standards." Traditionally, the Commission used a somewhat indeterminate number of considerations in judging rate reasonableness. As this approach did not directly relate to the efficiency of the rate at issue, the results were not acceptable, and the Staggers Act mandated the consideration of demand-based ratemaking. The Commission adopted such guidelines for coal in Ex Parte No. 347 (Sub-No. 1), and there have been two applications of these guidelines since they became final:

Omaha Public Power District	No. 38783	2/ 1/82	11/20/86
Arkansas Power and Light	No. 36719	9/26/77	5/13/87

More recently the Commission has proposed additional tentative guidelines to be applied in instances where the Ex Parte No. 347 (Sub-No. 1) guidelines will not work, or are too expansive. There have been tentative, as yet non-final, applications of parts of these guidelines in two instances:

McCarty Farms	No. 37809	3/27/81	5/27/87 (ten.)
South-West Car Parts	No. 40073	12/12/85	7/10/87 (ten.)

Additionally, the Commission has made various other determinations on issues of variable costs, car hire charges, and unreasonable rates practices, in which captive shippers have been given relief. But it would be inaccurate to characterize the analysis as stemming from "generally applicable standards". Most such cases involve unique issues of fact and law.

Rockefeller

17. How many times has the ICC, at any level, determined that a shipper is not subject to market dominance due to product or geographic competition? Please give me the name, docket number, date of decision, and whether that determination was overturned by either the Commission or a Federal court of appeal.

The attached chart lists cases pending on or filed after October 1, 1980 in which effective product or geographic competition contributed to a finding of no market dominance.

Review of Commission Decisions Finding Geographic or Product Competition

	Name	Docket No.	Date	Type of Competition Found	Overturned on Appeal?
I.	Non-Section 229 Cases				
1.	Incentive Rate on Coal -- Axial, CO, to Coleto Creek, TX	No. 37226	1/15/80 (EC)1/	Geographic.	No. (After voluntary remand, dismissed at complainant's request prior to EC decision.)
2.	The Aluminum Assoc., Inc. v. Akron, C.&Y. R. Co.	No. 37466	6/8/83 (EC)	Product, geographic, intramodal, intermodal.	No. (Dismissed per settlement prior to EC decision.)
3.	Procter & Gamble Co. v. Chicago & N.W. Transp. Co.	No. 37630	7/30/81 (ALJ)2/	Product, intermodal.	No. (Dismissed per settlement prior to EC decision.)
4.	Soo Line R. Co. v. Chicago & N.W. Transp. Co.	No. 39176 (Sub-No. 2)	9/25/84 (ALJ)	Intermodal, geographic.	No. (Dismissed at complainant's request prior to EC decision.)
II.	Section 229 Cases				
1.	The Aluminum Company of America v. Burlington Northern, Inc.	No. 37715S [Consolidated with Nos. 37723 and 37765.]	4/11/83 (ALJ)	Geographic, product.	No. (No appeal filed.)
2.	Consumers Power Co. v. Norfolk & W. Ry. Co.	No. 37857S	7/1/83 (ALJ)	Geographic, product.	Yes. (RB3/ decision served 2/T6/84.)

1/ Entire Commission.

2/ Administrative Law Judge.

3/ Review Board.

	Name	Docket No.	Date	Type of Competition Found	Overturned on Appeal?
3.	Salt River Project Agricultural Improvement and Power Dist. v. The Atchison, T. & S.F. Ry. Co.	No. 38086S	11/29/83 (RB)	Product, geographic, intramodal, intermodal.	No. (On voluntary remand of RB decision, EC affirmed result. No further appeal taken.)
			8/30/85 (EC)	Product, geographic.	
4.	Salt River Project Agricultural Improvement and Power Dist. v. Southern Pacific Transp. Co.	No. 38087S	11/25/83 (RB)	Product, geographic, intramodal, intermodal.	No. (Affirmed by D.C. Circuit.)
5.	Arizona Public Service Company v. The Atchison, T. & S.F. Ry. Co.	No. 38088S	7/28/83 (RB)	Intermodal, geographic, product.	Yes. (RB decision vacated and remanded D.C. Cir. 1984.)
			4/29/87 (EC, on remand)	Product, geographic, intermodal.	No. (No appeal filed.)
6.	General Electric Co. v. The Baltimore & O. RR. Co. Northern, Inc.	No. 38125S	10/22/84 (Div. 1)4/	Intramodal, geographic.	Yes. (EC decision 3/25/87.)
7.	General Electric Co. v. The Alton & Southern Ry. Co.	No. 38187S	3/12/84 (ALJ)	Intermodal, intramodal geographic.	Yes. (Div. 1 decision 10/29/84.)
8.	McGraw Edison v. The Alton & Southern Ry. Co.	No. 38238S	9/14/83 (ALJ)	Intermodal, geographic.	Yes. (RB decision 3/30/84. Aff'd by Div. 2 4/25/86.)
9.	Amstar Corporation v. The Alabama Great Southern RR	No. 38239S	7/17/84 (RB)	Intramodal, intermodal, geographic, product.	No. (EC granted voluntary remand to reconsider RB decision.)

4/ 3-member division of the EC.

	Name	Docket No.	Date	Type of Competition Found	Overturned on Appeal?
10.	Eli Lilly & Co. v. Burlington Northern, Inc.	No. 38262S	7/27/84 (RB)	Intramodal, intermodal, geographic.	No. (No appeal filed.)
11.	Allied Chemical Corp. v. Ann Arbor RR System	No. 38412S	6/10/85 (EC)	Geographic, product, intermodal	Yes. (D.C. Cir. 5/1/87.)

Rockefeller

18. You testified that you have cut your rate case docket in half. How many of these dispositions have been settlements?

Actually, we have cut our rate docket by closer to two-thirds than by half. From February 21, 1986 to June 15, 1987, 51 cases were closed. Thirty-six were dismissed at complainant's request or on the parties' joint request, presumably as the result of settlements.

As this issue has been raised a number of times, I would like to comment on the allegation that settlements do not represent or reflect any Commission action. This is simply wrong. Considerable staff work was done in all the settled cases ranging from a myriad of procedural orders to docket management conferences. It is often Commission action at an intermediate stage of the case or action in another related case that prompts settlement.

For example, on May 22, 1987, we issued a lengthy decision in No. 37437, Arizona Electric Power Cooperative, Inc. v. Atchison, Topeka & Santa Fe railway Co., et al. That decision was not a final decision applying our coal rate guidelines. It was an intermediate decision addressing numerous motions regarding market dominance issues and stand-alone cost evidence. Nevertheless, as a result of it, combined with the parties' perceptions of how we had applied the coal rate guidelines in other cases (and, thus, how we were likely to do so in this case), the parties apparently have settled their dispute. On July 10th, we received a request from complainant to hold the case in abeyance "in contemplation of dismissal" because the parties reached an agreement in principle.

The Commission supports and encourages private dispute resolution such as this. But our role must be recognized. In this case, a most conservative estimate of staff time spent would exceed 1,000 hours.

Danforth

There is general agreement that only 15% or less of shippers are captive and that the remaining 85% or more benefit from being free of regulation. If the CREA passed as is, how many shippers would be subject to regulation?

As indicated in other responses, the CREA bill would substantially shift the burden of proof on market dominance determinations toward the railroads. As a first approximation, the percentage of traffic found market dominant (and thus subject to rate review) would approach the percentage which is above the 180 percent (of variable cost, as measured by "Rail Form A") threshold. Our latest analyses indicate that this would amount to roughly 25% of all traffic.

The increased emphasis on the "management efficiency" or "Long-Cannon" factors of 49 U.S.C. 10707a(e)(2)(C), would mean that all railroad rates above 180% would be subject to review in every rate case.

The three access provisions would re-regulate far more traffic since they affect traffic where rates are low and there is no market dominance. The terminal trackage rights provision would require the Commission to indirectly regulate all traffic that originates or terminates in or near a terminal area. This would occur because the Commission would be required to establish conditions and compensation for use of the facilities. These are important factors in determining the rate charged to shippers. The reciprocal switching provisions would extend this to all traffic where reciprocal switching is practicable.

The joint rates section would extend re-regulation to all but the shortest haul traffic. It requries a carrier to offer regulated joint rates to any carrier that can interchange with it regardless of how many rail alternatives the shipper has and regardless of how inefficient the proposed new alternative is. Under this provision most of the 85% or more of rail traffic that is currently outside the Commission's jurisdiction would be re-regulated turning the clock back to the mid 70's when the Commission set rates, competition was ignored, maintenance was deferred and railroads were an endangered species.

In some ways the access provisions are worse than the pre-Staggers, pre-4 R Act environment since they are calculated to lower rates regardless of the impact on maintenance, investment or even survival of the system. This can be seen by contrasting a railroad's incentives now with incentives under this bill. Now, if a railroad defers maintenance or fails to modernize its investment its shippers complain and it may loose the traffic. (Even the sponsors of the bill admit that most rail traffic is competitive and has alternatives.) This risk of losing traffic is a strong incentive to spend scarce funds on maintenance and investment. By contrast if the shipper is served by another carrier under a strictly limited regulated rate, the incentives are reversed. Spending money on maintenance would bring no benefit to the original carrier itself and deferring maintenance would hurt only the shipper who had rejected it and the other carrier who was its rival. Even if the original carrier lowered its rates enough to keep the traffic it would have little incentive to maintain the line which would be only marginally profitable. In addition, the reduced rates would leave carriers little money to invest even if they wanted to.

PRESSLER

Let me ask a question on "revenue adequacy." There has been a great deal of emphasis placed on the fact that under the Commission's current guidelines, no railroad has ever been found to be revenue adequate. The impression we are left with is that "revenue adequacy" is the all-telling factor in determining whether relief will be granted. But the ICC has downplayed the "revenue adequacy" factor.

Could you explain to us how important a factor "revenue adequacy" is in these cases relative to other factors you consider? Specifically--and I know that no two cases are identical--but could you describe for the committee the four or five most important factors you consider in a rate reasonableness case, and the approximate relative weight in percentage terms you would assign to each vis-a-vis "revenue adequacy?"

The importance of "revenue adequacy" in rate reasonableness cases has been exaggerated and is widely misunderstood. All railroads are revenue inadequate, since none earn the cost of capital on their investments--yet findings of unreasonableness have been made against all carriers. Carriers that have collected unreasonable rates are then ordered to pay reparations to shippers, sometimes very sizeable reparations, despite the fact that they are "revenue inadequate." These reparations are in no way reduced because of the defendant carrier's inadequate earnings. Consequently, the validity of the proposition that revenue inadequacy is not a defense against an unreasonable rate ought to be self-evident.

Nevertheless, the issue of revenue adequacy continues to be the subject of controversy. This may be the result of a clash in cultures--the regulated culture of the electric utility industry (the principal source of the revenue adequacy controversy), versus the hybrid of competition and regulation that surrounds railroading. In the former, when the regulating agency finds that an electric utility is not earning its fair cost of capital (i.e., is revenue inadequate), the regulator raises the rate and the consumer pays the increase. Thus, the issue of revenue adequacy is often the beginning and the end of the rate case, a matter of the foremost importance. Quite to the contrary, in a rail rate case the issue is whether the rate is reasonable (the term efficient is a good, though incomplete, substitute) and the issue of revenue adequacy is not necessarily addressed directly at all. The Commission does make an annual determination of which carriers are revenue adequate, but having found that most or all are not, the Commission does not turn around and order rates increased. It has no power to do so, and even if it did, the increases could not be made to stick because nearly all rail traffic has alternatives, particularly as the horizon for choice is extended. Still, the fact that a railroad has been found revenue inadequate might understandably alarm individuals in whose industry such a finding would mean automatic rights to higher rates. It has no such meaning for rails.

This is not to say that revenue adequacy has no informative role in rail ratemaking. It does, and one that is largely beneficial to shippers. Prior to the Staggers and the 4R Act, the regulation of railroading was undertaken under the mistaken premise that the regulator could give first concern to issues of equity (false equity it turns out), balance of market share between modes, equal access to markets without regard to efficiency, and such. The result was a disastrous deterioration in rail plant. The revenue adequacy mandates of the 4R Act and the Staggers Act, coupled with the instruction to permit rates to vary with the demand for services, are important points of departure from the past. But in this sense, the requirements of revenue adequacy are no more than an intonation not to kill the goose that lays the egg. Failure to earn the cost of capital means exit, bankruptcy, or subsidy--alternatives that Congress understandably rejected. If it were firmly established that the goose was to be given at least the opportunity for nurture, or, put alternatively, if rail regulation did not have in its past several very anti-productive traditions, the revenue adequacy emphasis of the 4R Act and Staggers would be unnecessary.

There are other, more technical sides to the role of revenue adequacy in a rate case. (Our coal rate rules provide, for instance, that management inefficiencies, to the extent that they surpass any gap between earnings and revenue adequacy, may result in shipper reparations. Our coal rate rules also provide other, more direct means of assessing efficiency; and these have proven more accessible, avoiding the need for reliance on the revenue adequacy approach). But further discussion of the technical aspects would not change the two critical points that Congress should focus on. First, when the Commission looks at a rate, if it is unreasonably high (a determination that is not affected by the revenue adequacy status of the carrier), the Commission will award reparations to the captive shipper without regard to the fact that a carrier is revenue inadequate. Recent awards have established this proposition beyond debate. And second, when the

Commission finds that a carrier is revenue inadequate, the Commission does not have any power to increase that carrier's rates, and no such action is contemplated or generally desirable.

McCain

1. I appreciate your testimony regarding the progress made by the Commission in clearing up its docket. There are, however, still some cases that need to be resolved as soon as possible. Concerning the Arizona Electric Power Cooperative case, that has been pending since sometime in 1980, I understand that in an order issued recently the Commission hinted that it was finally moving toward a final decision on the utility's overcharge claim. Can you provide any further information as to precisely when this case will be decided?*

The reparations portion of the case will be decided by Labor Day, September 7, 1987, I made that promise to Senator DeConcini at a May 13, 1987 hearing before the Subcommittee on Antitrust Monopolies and Business Rights of the Senate Committee on the Judiciary. We are in the process of analyzing the parties' stand-alone cost evidence. Once that process is completed, a decision on the merits will be issued.

That part of the case involving relief for the future has been reopened to consider evidence of changed circumstances. In an order served May 22, 1987, the Commission moved to expedite this portion of the case by limiting the new evidentiary period to 90 days.

This case has been a priority since I became Chairman. Yet, as the attached chronology indicates, disposition of it was delayed for some good reasons. First, the parties asked the case be held in abeyance pending negotiations. As soon as they advised us that settlement was not possible, we issued a procedural schedule for receipt of evidence. Second, as can be seen from the chronology, the record was replete with motions and cross motions and a number of interlocutory decisions were required to get the parties back on track. The Commission acted promptly on those motions, despite their complexity.

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* On July 10, 1987, the Commission received a request from complainant to hold the case in abeyance "in contemplation of dismissal" because the parties reached an agreement in principle. On July 15, 1987, defendant filed a motion that it does not generally oppose AEPCO's motion. A temporary 30-day stay was granted on July 21.

INTERSTATE COMMERCE COMMISSION

ARIZONA ELECTRIC POWER COOPERATIVE, INC.
v.
THE ATCHISON, TOPEKA, AND SANTA FE RAILWAY CO., ET AL.

No. 37437 CHRONOLOGY SINCE 4/10/86

4/10/86 - After negotiations among the parties proved unsuccessful, the Commission served a decision setting a procedural schedule for determining the reasonableness of the involved rates under standards established in Ex Parte No. 347 (Sub-No. 1), served 9/3/85. Under that schedule, complainant's opening statement was due 5/19/86, defendants' statement was due 7/17/86 and complainant's rebuttal was due 8/15/86. In this decision, the Commission also denied complainant's motion to reopen and reconsider the capital incentive rate issue.

4/16/86 - Complainant filed its first set of interrogatories and verified document production request.

5/6/86 - Defendants filed their first set of interrogatories on complainant.

5/14/86 - Partial reply of defendant ATSF to complainant's first set of interrogatories and document production request filed.

5/20/86 - Defendants filed their second set of interrogatories to complainant and a verified document production request.

5/22/86 - Second partial reply filed by defendant ATSF to complainant's first set of interrogatories and document production request.

5/22/86 - Complainant filed its first motion to compel defendants to respond to its discovery requests.

5/30/86 - Complainant filed its second motion to compel defendants to respond to its discovery requests.

6/2/86 - Complainant filed its answers and objections to defendants' first set of interrogatories.

6/4/86 - Defendant ATSF replied to complainant's second set of interrogatories.

6/4/86 - Defendants filed a petition to hold this proceeding in abeyance pending the outcome of judicial review of the Commission's decision served 4/10/86. Complainant filed an appeal before the 9th Circuit on 4/28/86 contesting the Commission's resolution of the capital incentive rate issue in that decision. It was docketed in the 9th Circuit as No. 86-7233.

6/9/86 - Defendants filed their first motion to compel discovery.

6/12/86 - Complainant replied in opposition to defendants' petition to hold the proceeding in abeyance pending judicial review.

6/16/86 - Complainant filed a petition for modification of the procedural schedule for filing the parties' cases-in-chief to extend the due dates for statements by 40 days each.

6/20/86 - Defendants replied to complainant's second motion to compel discovery.

6/20/86 - Defendant SP filed its answers and objections to complainant's second set of interrogatories.

6/23/86 - Defendant SP filed its response to complainant's interrogatory No. 33.

6/24/86 - Complainant filed its answers and objections to defendants' second set of interrogatories and verified document production request.

6/27/86 - Complainant replied to defendants' first motion to compel discovery.

7/11/86 - Defendants filed their reply to complainants first motion to compel discovery.

7/11/86 - Acting Chairman Simmons granted complainant's request to extend the procedural schedule but denied defendants' petition to hold the case in abeyance pending the outcome of complainant's petition for judicial review in No. 86-7233. Under the new procedural schedule, complainant's opening statement was due 8/18/86, defendants' statement was due 10/20/86, and complainant's rebuttal was due 11/17/86.

8/18/86 - Director Mackall orally granted complaint's request for a 4-day extension of the procedural schedule.

8/22/86 - Complainant filed its opening statement of facts and argument. Thomas Crowley, who was not an engineer but rather is an economist, developed the route of movement and cost of construction of the stand-alone railroad that included some 187 miles of segment where no railroad currently existed. This study contained substantial deficiencies; for example, it reflected the costs involved in building a railroad across flat land, even though the route in question goes across mountains.

10/8/86 - Defendants filed a request to extend the time for filing their statement of facts and argument by 56 days.

10/10/86 - Complainant filed a reply in partial opposition to defendants' extension request.

10/23/86 - The Commission served a decision that granted document production requests filed by both complainant and defendants and that granted, in part, motions to compel answers to interrogatories filed by both complainant and defendants. The Commission also found that the record failed to show sufficient cause to reopen the issue of market dominance and denied defendants' discovery requests concerning that issue.

10/23/86 - Chairman Gradison issued a decision that granted in part defendants' petition to extend the time for filing their opening statement. The defendants had requested a 56-day extension, but were granted only a 30-day extension (as agreed to by the complainant). Defendants' statement was now due 11/24/86, and complainant's rebuttal was then due 12/22/86.

11/12/86 - Defendants filed petitions (1) to reopen the Commission's decision of October 23, 1986 denying discovery of evidence related to market dominance and (2) for supplemental discovery, cross-examination, and briefing related to market dominance. The bases for reopening were new evidence or changed circumstances regarding product and geographic competition and material error.

11/24/86 - Defendants filed their statement of facts and argument. Defendants included evidence and argument on market dominance as well as stand-alone costs. According to defendants, the single most important difference between their SAC and complainant's involved the cost of building the railroad complainant selected. Defendants argued that Crowley is not an engineer and that his analysis for constructing the railroad was so faulty and superficial as to require complete re-engineering of the route. Defendants pointed out further that the single most critical segment of the route specified by complainant was the 187-mile segment where there is no existing railroad. Defendants employed Jack Storm and Stephen Heath, who (unlike Crowley) are professional engineers, to develop their construction cost estimates. Their construction cost estimate was $4.2 billion, whereas Crowley's was around $409 million, thus resulting in the large difference between the parties for SAC. Defendants also included a motion for a protective order for part of its evidentiary submission.

11/26/86 - Complainant replied to defendants' petitions of 11/12/86 by requesting the Commission to postpone ruling on defendants' petitions until complainant filed its rebuttal. Since defendants included evidence and argument regarding market dominance in their statement for their case-in-chief filed 11/24, complainant argued that it must address those arguments in its rebuttal statement, and its response to the 11/12 pleadings will therefore be encompassed in that statement.

12/9/86 - Complainant filed a motion for an extension of 48 days in which to file its rebuttal statement.

12/12/86 - Defendants replied to Complainant's 12/9 extension request. They agreed to a 30-day extension. Defendants also filed a show cause order asking that complainant be required to respond within seven days to defendants' petitions of 11/12 regarding market dominance. Defendants further sought an order prohibiting the destruction of evidence related to their market dominance discovery requests.

12/15/86 - Complainant replied to defendants' pleading of 12/12.

12/22/86	-	Chairman Gradison served a decision granting a 30-day extension (until 1/26/87) to complainant for filing its rebuttal. Chairman Gradison denied defendants' show cause petition and petition for order prohibiting destruction of evidence filed 12/12.
12/24/86	-	Chairman Gradison granted in part a petition filed by defendants that sought an order protecting the confidentiality of certain information filed with their 11/24 statement.
1/27/87	-	Complainant filed its rebuttal addressing both market dominance and stand-alone cost. In rebuttal, complainant presented for the first time SAC evidence based on the work of a professional railroad engineer - E.Q. Johnson. Complainant changed the route slightly, but the changes resulted in substantial cost reductions from defendants' estimates. Complainant also for the first time introduced a computer program for estimating the grading requirements.
1/27/87	-	Complainant also petitioned for leave to file its rebuttal one day late due to the snow storm in the Washington area and for a protective order.
2/17/87	-	Defendants filed: (1) a supplemental petition to their petitions of 11/12/86 regarding market dominance; (2) a motion to strike or, alternatively, file a supplemental reply to complainant's rebuttal SAC evidence; and (3) a motion to cross-examine two of complainant's SAC witnesses (Johnson and Downing).
3/9/87	-	Complainant filed a consolidated reply in opposition to defendants' 2/17 motion to strike, motion for cross examination, and supplement to petitions filed 11/12/86.
3/19/87	-	Defendants filed a supplemental reply to complainant's rebuttal SAC evidence to avoid delay if the Commission should decide to grant this form of relief requested on 2/17. Defendants also included further evidence and argument regarding market dominance.
3/23/87	-	Complainant submitted a letter of protest to defendants' filing of SAC reply on 3/19. Complainant argued that the proferred testimony should be rejected and their motion be denied. If the motion should be granted, complainant asked for 30 days in which to reply.
4/14/87	-	Defendants submitted a letter in rebuttal of complainant's rejection argument of 3/23.
5/22/87	-	Entire Commission decided: (1) to accept complainant's new SAC evidence and defendants' reply; (2) to allow complainant to file rebuttal within 30 days; (3) to refuse to reconsider market dominance finding for past movements and proceed to reasonableness determination for past movements; and (4) to take more evidence on market dominance for the future within 90 days.
5/29/87	-	Defendants filed a motion to reopen the May 22nd decision and modify it: (1) to defer any action on rate reasonableness with respect to past movements until the Commission has had the opportunity to consider the additional market dominance evidence permitted under that decision; and (2) to grant

their motion of February 17th to cross-examine two of complainant's stand-alone cost witnesses.

6/17/87 - An administrative law judge was assigned to the proceeding for the purpose of handling the taking of evidence on the issue of market dominance for the future.

6/22/87 - Complainant filed its rebuttal evidence to defendants' March 19th supplemental reply to AEPCO's new stand-alone cost evidence. Complainant also filed a motion for a protective order and a letter containing arguments by complainant's attorney.

McCain

2. From a review of the recent history of the Arizona case, it appears that the utility has spent most of the last year responding to various railroad motions to reopen issues that already had been settled, and that this has delayed a final decision on the merits by the Commission. Does the Commission have rules that keep parties from dragging cases on by filing repetitious motions and other similar paper? How do you intend to handle the matter in this case?

The Commission ensures that its procedures are not abused. At the same time, we must guarantee the parties due process. Thus, while this particular case involved numerous evidentiary and procedural challenges by both sides, the Commission is neutral, and here has addressed all the parties' arguments on the merits.

The motions to reopen filed within the last year by the railroads primarily involve the issue of market dominance. By statute (49 U.S.C. 10709), market dominance is jurisdictional and, as a matter of law, can be raised at any time. Courts do not countenance rejection of jurisdictional arguments even if they are raised late in the proceeding. In any case, we were faced here with new evidence of changed circumstances which the railroads brought to our attention promptly.

We reopened the issue of market dominance for future movements only. As we stated in the decision, reopening will not deny adequate relief to complainant since a considerable portion of the case and any monetary award concern reparations for movements up to the decision date. We explained that we are proceeding with that portion of the case and will issue a decision as soon as we have completed our analysis of the parties' stand-alone cost evidence. A second decision will follow on complainant's request for a prescription for the future.

I have been especially concerned about footdragging by litigants and we have adopted a number of procedures to prevent it. We call docket management conferences and issue special orders to keep cases moving and, as I noted earlier, in this case we have limited the reopening period to avoid delaying the second part of the case any further.

3. The record shows that the rate Arizona Electric is challenging is at least double and almost triple the levels set on competitive movements. For example, the City of San Antonio--in a contract made public--obtained a rate that was about 12-1/2 mills per ton-mile once its traffic became subject to competition. The Arizona Electric rate by contrast, is over 30 mills ($16.00 divided by 505 miles = 31.6 mills). Wholly apart from the question of the reasonableness of such a rate under your Coal Rate Guidelines, doesn't this comparison basically remove any doubt about market dominance? Why would a utility with effective alternatives willingly pay such a high rate?

The statutory scheme for rail rates envisions a two-pronged test: first, whether the carrier has market dominance, and second, if there is market dominance, whether the rate is reasonable. In 49 U.S.C. 10709(a), market dominance is defined as an absence of effective competition from other carriers or modes of transportation for the transportation to which a rate applies. The focus in the definition is on "effective competition." Basing a market dominance determination on the level of the rate compared to another rate would prejudge the rate as being a high rate when we do not know whether the underlying transportation conditions for the rate and the compared rate are similar. Indeed, the courts have in the past uniformly rejected such an approach as arbitrary.

Commission decisions -- especially on jurisdictional matters -- are subject to strict scrutiny by the courts. Whatever our impressions may be, we must develop a record that will support our ultimate conclusions. In doing so, we must ensure that no party can later claim to a court that it was denied a hearing on a relevant issue. This is especially important where, as here, defendants have the burden of proof on key aspects of the market dominance determination.

4. When the Arizona Electric case is decided, will it be under the same guidelines used in the Omaha and Arkansas Power & Light cases, where the shippers received significant reparations awards?

This case will be decided in accordance with the Commission's maximum coal rate guidelines, as was Omaha and Arkansas Power and Light. Each case must be decided on its own merits, however, and it cannot be inferred, because reparations were awarded in those cases using the guidelines, that the same result will necessarily occur in this case.

Senator ROCKEFELLER. We will move on now to the next panel, a panel of railroad executives: Drew Lewis, President and Chief Operating Officer of Union Pacific Corporation; Mr. Darius Gaskins, President and Chief Operating Executive Officer of Burlington Northern Railroad; Arnold McKinnon——

Senator KASTEN. Mr. Chairman?

Senator ROCKEFELLER. Senator Kasten, yes?

Senator KASTEN. Mr. Chairman, I would like to ask unanimous consent that Senator McCain be permitted to submit questions for the record to Chairman Gradison.

Senator ROCKEFELLER. Of course, that will be done.

Arnold McKinnon, who is the Chairman and Chief Executive Officer of Norfolk Southern; and John Snow, President and Chief Executive Officer of CSX Transportation; also, Mr. Richard Kilroy, Chairman, Railway Labor Executives' Association.

Mr. Kilroy, if you could hold for a minute, we will just have these four chief executives.

Gentlemen, we welcome you, and is there any order in which you would wish to give testimony?

Mr. Lewis, do you want to start?

STATEMENTS OF DREW LEWIS, PRESIDENT AND CHIEF OPERATING OFFICER, UNION PACIFIC CORPORATION; DARIUS W. GASKINS, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, BURLINGTON NORTHERN RAILROAD CO.; ARNOLD McKINNON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, NORFOLK SOUTHERN CORPORATION; AND JOHN W. SNOW, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CSX TRANSPORTATION

Mr. LEWIS. Thank you very much. First of all, I have submitted written testimony, and with your approval, Mr. Chairman, I would like to have it in the record. What I would like to do is make a few disoriented remarks, if you would approve of that, in terms of responding to the first testimony and not really reflecting on what I submitted for the record. Obviously, you can interrogate me on that.

This really responds to some of the questions. I think they are more addressed to you, Senator Rockefeller, than they are to other members of the panel because of your interrogation of Heather Gradison.

I would just like to talk in terms of Union Pacific Corporation and how we react to the Staggers and how I come down as someone who was involved in this situation in 1980 and 1982.

First of all, I am a very strong supporter of deregulation, and deregulation really took place under the Carter Administration. I think that administration did a much better job than we did in the Reagan Administration in terms of freeing the economy of the burdens of government.

As far as the Union Pacific is concerned relating to not only your interrogation of Mrs. Gradison but the testimony of last week, we earned in 1986 $385 million in the railroad, which I am sure you think is a very large sum. In the same time period, we invested $495 million. This year we are going to invest more in the railroad than we are going to receive in earnings.

If you want to look at rail rates, which you are concerned about, post-Staggers, our carloadings are up. This month they are up 13 percent. For the year they are going to be up between 5 and 10 percent. Our revenue per ton mile is down.

Basically, we have had a decline in rates of 32 percent on a real dollar basis since the Staggers Act. During the same time we have improved earnings. We have improved earnings at the expense of labor, and my colleagues on the labor side of our industry, whom you will hear from later, are here today; but basically what we have done is we have dropped our employees from 52,000 to 32,000. By the end of this year we are going to be at 30,000, and we can actually operate the railroad with 25 percent less people than are presently on the payroll.

Grain, which I am sorry Senator Exon is not here, is actually down 33 percent, and so we are reducing rates, and we are much more competitive. We are not only competitive with my colleagues to the right, but we are competitive with trucking, which is really where the act is as far as we are concerned.

From an investment standpoint, if you had to rebuild our railroad today you would spend somewhere between $16 and $20 billion. There is nobody in this room that would consider investing in a railroad in terms of the cost, forgetting about the acquisition of right of way which was given to us by the Federal Government, and obviously we went through a few bankruptcies, and I think that has been wiped out.

Nonetheless, we have a tremendous investment, but during the time period since Staggers we have not had one legal action filed against the Union Pacific Corporation. We have no lawsuits. If we have a problem with our customers, we like to deal with our customers and work it out with them and not have you interfere with our interaction in terms of how we solve their problems.

What I want to do is I want to keep our railroad competitive so our coal moves out of the Union Pacific territory to compete again with the three gentlemen to my right. I have to compete with Burlington Northern on a day-to-day basis. I have to compete with trucks, and also I would like to be able to compete with West Virginia coal.

So, therefore, what we have to do is keep our rates down so we keep our industries competitive.

I think another isolated comment which you did not refer to today but I am sure you will later is if things are so bad, why are we acquiring all these companies? The answer is we acquired a trucking company which serves the Eastern United States for $1.2 billion. We borrowed $1,200,000, and the reason we did it is we want to try to diversify. We are looking into the hazardous waste business, which you have probably read in the Wall Street Journal.

We are trying to figure out how we support a business with a tremendous capital investment, where our revenues are flat and going down and the only way we can survive is by cutting costs.

I guess you could say, well, if all this is true, why do you stay in the railroad business, and the answer is we are in it. There is no way to get out, and it can be a very good business, but I think it can only be a good business if instead of talking about reregulating us you give us some relief on FELA, on railroad retirement and permit this industry to operate like every other industry does in this country, with the same kind of antitrust laws and all the other conditions that exist in what I would consider a normal private sector enteprise.

I guess what I am saying in just finalizing my comments is that I think Staggers has been successful. I think deregulation is the right route to go, and I would like you to permit us to give it a chance to work a little longer. If it does not work, you can always, if you are upset with the ICC, give some more regulation to them, give them some more power, give them more regulation, but do not give us more problems.

Thank you, sir.

[The statement and questions and answers follow:]

Statement of Drew Lewis, President, Union Pacific Corporation

Mr. Chairman and Members of the Subcommittee, I am Drew Lewis, President of Union Pacific Corporation. I am pleased to be here today to comment on how Union Pacific Railroad has fared under the Staggers Act as part of your examination of the health of the rail industry. I hope that by elaborating on Union Pacific's experience and how we are responding to today's challenges, you will have a better understanding of why legislation such as the CURE bill would be so harmful to the rail industry.

UNION PACIFIC'S FINANCIAL CONDITION

Union Pacific Railroad's financial performance over the past ten years has been mixed. By some measures, we are not much better off today than during the 1970s. Under Pacific, and Missouri Pacific Railroad with which Union Pacific merged in late 1982, both earned returns on investment of between 7½ and 8½ percent in the late 1970s and early 1980s. Our return then fell to between 4 and 5 percent from 1982 through 1984, as many of the Railroad's traditional customers suffered the effects of recession. In 1985, our return rose to 6½ percent. For 1986, we estimate it at less than 2 percent because of the need to write off assets and take special charges in connection with a comprehensive restructuring effort, including an employee buy-out program.

Since we are essentially in the same position today with respect to rate of return as we were prior to Staggers, I do not think it is fair to say that the railroads are reaping inordinate profits from rail deregulation. I do believe, however, that Union

Pacific and the other railroads are, on the whole, more financially stable than we were ten years ago.

Union Pacific Railroad's net income has also fluctuated over the past decade. From 1977 through 1981, net income for Union Pacific and Missouri Pacific combined rose an average of 9% per year. Net income in 1977 was $225 million and by 1981 had increased to $315 million. But in 1982, the Railroads' combined net income dropped by a third, down to $214 million. It was 1985 before earnings fully recovered. In 1986, net income from railroad operations rose to $385 million excluding write-off charges, a significant improvemet but still well below the $475 million level that would hae prevailed had the upward trend of the pre-Staggers era of the late 70's and early 1980's continued. We have embarked on a rigorous cost reduction program, and anticipate that we will do better at the bottom line in 1987.

Your reaction to these earnings figures may be that if Union Pacific is earning three-digit profits, we are financially sound and should be deemed revenue adequate for regulatory purposes. But consider this: every year during the past decade, Union Pacific Railroad had to invest substantially more than it has been able to earn. Capital investment on plant and equipment has run from a low of $341 million in 1983 to a high of $667 million in 1980. The following table summarizes Union Pacific's earnings and capital investment for the last ten years:

UNION PACIFIC RAILROAD-MISSOURI PACIFIC RAILROAD—EARNINGS AND CAPITAL INVESTMENTS

[Dollars in millions]

	Capital investment	Earnings
1977	$374	$225
1978	429	241
1979	561	261
1980	667	288
1981	660	315
1982	567	214
1983	341	245
1984	607	311
1985	657	322
1986	494	385

The improvements that we have been able to make in net income over the last three years have not come from rate increases. Carloadings have recently risen and revenues have stayed flat—$3.8 billion in both 1985 and 1986 although net income rose by $63 million. In fact, on an inflation-adjusted basis, revenues actually declined by almost 20% from 1978 to 1986. All of the recent enhancement in earnings is attributable to reductions in operating expenses. Even those who are the most critical of the Staggers Act would be forced to admit that cost reductions such as the one Union Pacific is making are driven by competition and the need to offer competitive rates to attract and keep customers. If there were not such extensive competition for the transportation dollar, we would not be going through a very painful reduction in the size of our work force. We could simply raise rates on a selective basis to increase revenues and return on investment.

Other statistics and financial measures tell the same story—that competition and cost cutting are shaping the rail industry on the post-Staggers Act environment. Under Staggers, revenue per ton-mile has been virtually unchanged from 1980 to 1986 at 2.7¢ per ton-mile. If we take inflation over this period into account, our revenue per ton-mile declined 32% on a real-dollar basis.

What should come across from all of these statistics is that Union Pacific is a financially stable company committed to being an efficient, capable rail carrier. But it should also be recognized that Union Pacific's financial performance and that of the rail industry as a whole is still off the mark. Even under the Staggers Act, we have experienced sharp swings in our traffic levels and revenues. The flexibility afforded under Staggers to quickly adjust to changing market conditions has certainly helped us weather hard times and tougher competition by working with our shippers. Nevertheless, we still have quite a ways to go.

CONTINUING CONCERNS

Although not at the rapid pace of previous times, the railroads are still losing market share. In 1980, the railroads moved 29% of all domestic intercity freight tonnage. By 1986, our share had fallen to 26%. Although some have expressed concern about the increasing concentration of the rail industry through mergers, there is no evidence to indicate that the railroads have been able to the recapture much lost traffic or raise rates through consolidation.

Our reliance on bulk traffic is still rising. Since 1981, the percentage of Union Pacific's revenues coming from bulk commodities has increased from about 58% to 62%. Approximately one of every four carloads on Union Pacific in 1986 was coal. Aggregates, grain and chemicals comprised another 30% of our traffic.

Our ability to compete for higher-value traffic, while helped by Staggers, has been negatively affected by marketplace changes. In less than five years, shippers have shifted to just-in-time delivery systems to reduce inventory carrying costs and service commitments required of carriers are substantially more demanding as a result. Transporters are expected to be a partner in the marketing of the product, not merely another segment in the distribution chain. Many shippers are relying on fewer carriers today, while others have chosen to get into the transportation business themselves. Just-in-time inventory systems favor the flexibility of motor carriers. the railroads are still able to compete, but we must often provide a significantly lower rate in order to compensate the shipper for a somewhat longer delivery schedule.

We are also concerned that heavy-loading traffic is becoming more susceptible to diversion to the highways. In the past several years, some progressive truckload carriers have been able to reduce their operating expenses by about 28%, through such things as improvements in fuel efficiency and a higher ratio of loaded to empty miles. Labor expenses are significantly lower than for the rail industry. For the railroads, labor costs represent 44 percent of total operating expenses, compared to 36 percent of operating expenses for motor carriers. The wage differential is substantial. The average truck driver makes about $27,000 per year compared to $41,000 per year for each member of a rail crew.

Size and weight increases have also improved the trucking industry's competitive position. The majority of states within Union Pacific's operating territory are now authorizing a gross weight limit above 80,000 pounds on at least some highways and the truckers are seeking blanket authorization of Bridge Formula B weights in the 17 Western states. I cannot overstate the impact that the so-called "pinwheel amendment" would have on the western railroads, especially if user charges are not raised to reflect the cost of road damage caused by higher weights.

THE NEED TO REFORM FEDERAL PROGRAMS

There are several significant problems facing our industry which need to be solved here in Washington. The railroads remain burdened by specialized programs established by Congress in an earlier era. Times have changed and the rail industry can no longer afford to continue to operate under the old rules.

Our foremost concern is Railroad Retirement, the rail industry's separate, Federally administered retirement program. Railroad Retirement is currently costing Union Pacific $250 million per year. At this stage, we are essentially paying 22% of the taxable payroll to the Railroad Retirement Fund and our employees are contributing another 11%. In essence, we are paying today for the railroad failures of the past. The surviving carriers and their employees are supporting retirees once employed by the Penn Central, Rock Island and other railroads no longer in business. Each employee currently working in the industry is supporting three retirees, a condition far more critical than that of Social Security where there are three active workers for each one retiree. Yet even at this cost the Railroad Retirement Board has determined that the system is inadequately funded and has recommended increasing the Tier II tax by 1.5 percentage points in each of the next two years.

The Railroad Retirement System has suffered perennial funding problems since the mid-1970s. Every few years, we settle upon another solution and have false hopes that the System will be financially sound for the long term. Tax increases on the carriers have been stiff. In 1981, the Tier II tax on employers was 9.5%. Today, it stands at 14.75% of a higher wage base. We canot continue down this path. We think it is time for a comprehensive study of railroad retirement issues so that some realistic long-term solutions can be developed.

A second major concern is the Federal Employers Liability Act (FELA), the statute governing compensation to railroad workers for personal injuries. FELA is another program that is unique to the rail industry. Virtually all other employees, including those of our trucking competitors, are compensated under no-fault state worker's compensation programs. In 1986 alone, Union Pacific's payout under FELA was $75 million.

FELA is not in the best interest of either the carriers or our employees. Let me cite just a few of the problems. Over 40% of actual FELA payout each year are going for attorneys fees and other administrative expenses. Unless claims are voluntarily negotiated to settlement, all FELA cases must be litigated. Employees receive double recovery under FELA for sickness benefits and lost wages paid, respectively, through the railroad unemployment insurance program and by the carrier. There is no consistency among awards. Two employees having the same injury will often receive significantly different amounts of compensation. There is no incentive under the Act for the employee to seek rehabilitation. On the contrary, it is often in the employee's interest not to return to work in order to build up the size of the economic losses and the potential FELA award.

Some very unfair results occur under FELA. Let me cite two recent cases. This past March, a Union Pacific employee was awarded $704,000 for a relatively minor knee injury sustained while unloading ties from a gondola car. The injury had required the same surgery that was performed on Joni Benoit seventeen days before she ran and won a marathon to qualify for the 1984 Olympics. The basis for the award was that Union Pacific should have used mechanical equipment to unload the ties, despite the fact that this task is often done manually with limited risk of injury. In another case, a jury awarded $2 million for a back injury.

The railroads are also under a separate system for unemployment compensation. Under the Railroad Unemployment Insurance program, or RUIA, railroad employees are entitled to unemployment, sickness and strike benefits. RUIA represents a $30 million expense to Union Pacific on an annual basis. As with Railroad Retirement, given the heavy loss of employment in the railroad industry with the bankruptcies of the '70s and recession in the early '80s, the RUIA fund is deeply in the red. It has borrowed from Railroad Retirement and today's railroads are being assessed to repay that debt and to pay the current costs of the program. We are in a situation where we as a rail employer pay more into the unemployment fund in taxes and an unemployed rail worker get less in unemployment benefits than is the case under the unemployment systems of almost all the states.

Labor protection is another costly item, and another cost our truck and barge competitors do not bear. We are concerned that Congress may go further and mandate that the ICC impose significant labor protection costs in connection with the sale of lines to new shortline operators. Our current expenditures for *New York Dock* protection, which provides railroad employees affected by a merger or abandonment up to six years salary, are significant. Some light density lines can only survive if operated by low cost shortlines which are not subject to the national labor agreements. If Congress mandates that labor agreements carry over when these lines are sold, they will have to be abandoned. Shippers and communities will lose service and the traffic that could be generated on these lines will be lost to the rail system.

HOW THE STAGGERS ACT HAS ENHANCED COMPETITION

I would like to devote most of the remainder of my testimony to how the staggers act has enhanced competition and shaped Union Pacific's financial performance.

I think the provisions of the Staggers Act that have had the biggest impact on Union Pacific's financial performance are those that authorized contract rate agreements, expanded the Commission's authority to exempt rates and service from regulation and abolished the railroads' ability to collectively set rates. With the exception of the Rail Cost Adjustment Factor, which has ensured that the railroads can recoup inflationary cost increases where market conditions so allow, the rate freedoms under Staggers have generally been of secondary importance since competitive pressures have largely precluded rate increases beyond inflation.

CONTRACTS

Contracts have enabled the railroads to tailor rate and service arrangements to a shipper's individual needs. Nearly all have provided shippers lower rates in exchange for volume commitments. While the rail business is subject to more competitive pressures today, contracts provide a measure of stability in that carriers can lock in traffic for a given period of time. Since nationwide about 50% of all rail traffic now moves under contract, each carrier's ability to compete effectively for and secure contract traffic now has a major influence on the railroad's financial performance.

Union Pacific has filed about 7,500 contracts with the ICC. Many other contracts covering traffic exempt from ICC regulation have also been concluded. All but four of the agreements have provided rate decreases from the previous tariff charge. Today, over 80% of Union Pacific's coal business and over 70% of our grain traffic moves under contract arrangements. Much of this traffic originates or terminates at points served only by Union Pacific. Soda ash, a dry chemical used in the manufacture of glass, is often cited as an example of a "captive" commodity. Yet significant market forces are present—truck/rail competition; geographic competition from a California soda ash deposit on the Southern Pacific; product competition from synthetic soda ash produced in Canada and from cullet (ground glass). Forty percent of our domestic soda ash traffic and 100% of our export business is now under contract, despite the "captivity" of soda ash to Union Pacific.

Most of our coal contracts involve utilities that are served by only one railroad at origin and/or destination. This has not prevented these utilities from obtaining rate reductions from the railroads. Intramodal competition for coal traffic is significant. Union Pacific and the Chicago North Western, for instance, have concluded a contract with City Public Service Board of San Antonio. We were able to lure this traffic away from Burlington/SP even though at the time of contract negotiations, SP was the only delivering carrier.

Other forms of competition come into play. Union Pacific has main line trackage running parallel to the Mississippi and must compete head-to-head with barges for deliveries of coal to the mid-South and Gulf. Coal competes with other fuels and there is competition among alternative coal mines. For example, Central Power & Light Company, a CURE member, recently solicited bids from spot coal suppliers for 300,000 tons of coal for its "captive" Coleto Creek Station. It received a total of 43 bids from 37 coal companies and has narrowed its list down to nine sources, including two suppliers in Columbia.

The contract ratemaking provisions of the Staggers Act have also been highly beneficial in enabling us to work with our shippers to promote American exports. Union Pacific has worked closely with our shippers to do our part. As one example, UP has worked hand-in-hand with the American Natural Soda Ash Corporaton (ANSAC), to which all of the Wyoming producers belong, to increase soda ash exports. Last year, exports increased 13%. We hope to see a further 10% increase this year.

It bears reiterating that all of these favorable changes have come about through reliance on market forces rather than regulation. Where needed, maximum rate review is still available from the Commission.

EXEMPTIONS

Exemptions have also played an important role in the deregulated environment. The Staggers Act broadened the Commission's authority to exempt from regulation providing that even if an exemption is not of limited scope, the ICC may still approve an exemption if it concludes that regulation is not necessary to protect shippers from an abuse of market power. In the first several years following approval of the Staggers Act, the Commission used its exemption authority liberally. While several of the Commission's exemption proposals including boxcar deregulation were quite controversial, we strongly support the ICC's bold approach. It is essential for a health rail industry that traffic meeting the statutory criteria be exempted from ICC oversight.

The single most important exemption to date has probably been the exemption of piggyback traffic from regulation. Intermodal traffic is the fastest growing segment of our business, increasing 23% in 1986 alone. This growth is in large measure due to our flexibility in a deregulated environment to meet market demand quickly. We can adjust rates without the need to provide lengthy notice to the ICC.

Intermodal traffic is highly truck-competitive and like contract movements is characterized by rate decreases. Over a number of years, piggyback has gone through an evolutionary process. Shipments initially consisted of truck trailers. Later, container shipments picked up as mini-bridge service became competitive with all-water shipping. Today, the "hottest" part of intermodal is double stack trains—two containers "stacked" on single platform. Union Pacific moved its first double stack train in 1984. Between 1985 and the end of 1986, our double stack business doubled. We are currently operating 28 double stack trains per week from West Coast ports and we expect this traffic to continue to grow.

There are two points about intermodal traffic that should not be overlooked in your review of recent changes in the rail industry. First, the growth of intermodal traffic has not been enough to offset the decline in railroad merchandise traffic. Secondly, developments in the intermodal area (and with truck-rail car reload programs) have further enhanced competition. A railroad can now readily extend its market penetration well beyond the reach of its track.

ABOLITION OF COLLECTIVE RATEMAKING

The railroads trade-off in 1980 for additional rate and service freedom was the revocation of our ability to discuss and collectively set rates through rate bureaus. Congress reasoned that if rail carries were to be permitted to compete more effectively with motor and water carriers, we should also be forced to compete more one with another.

The abolition of collective ratemaking put an end to rate equalization and forced the railroads to compete with one another on price. Under the prior regulatory regime, the same rates had applied to all possible routes between a given origin and destination. What competition there was between carriers was based on service rather than price.

Although many contend that the rate and route cancellations that occurred after the Staggers Act was passed were anti-competitive, it was precisely the new rail-to-rail competition fostered by the Act that forced carriers to concentrate on their most efficient, lowest cost routes. Since competition is now mainly on price, carriers cannot offer shippers more attractive rates without improving routing efficiency and lowering operating expenses. Carriers were also forced to cancel some rates to simplify their rate structures. It is one thing to be able to vote up or down on thousands of rates in a matter of minutes through a rate bureau. It is quite another to have to discuss each rate individually with connections.

The revocation of antitrust immunity to collectively set rates has also encouraged railroad mergers. The need today to obtain the concurrence of each connection on every rate gives rail carriers that can provide single line service a distinct advantage. Protracted negotiations with connections can be avoided and it is easier to negotiate contracts. In addition, eliminating interchanges by merging with another railroad cuts shipping expenses. The efficiencies translate to lower costs and lower rates.

I know some concern has been expressed about recent railroad mergers. But it has been our experience that the recent mergers have intensified competition. In the West, for example, there is intense price competition today between ourselves, Burlington Northern and Santa Fe on grain traffic. Today's railroads are more effective competitors because with interregional operating systems, we can provide single line service for a sizable portion of our traffic. We can offer competitive rate and service packages without discussions about rate divisions and service requirements with connections. Competition has been heightened. Given the fact we are operating in a national market exemplified by intense source competition, our grain rates are constrained by what the Burlington Northern is charging shippers in the Dakotas and what the Santa Fe is doing in the Texas panhandle, areas we do not serve. At the same time, the other carriers are impacted by pricing actions taken by Union Pacific.

Single line service also increases a railroad's market penetration area. With respect to grain, this means farmers may find it more economical to truck grain 50 miles to Union Pacific rather than move the grain rail direct from an elevator served by another railroad.

UNION PACIFIC'S RAIL NETWORK

Union Pacific is committed to the railroad business. While we are looking at selling some marginal branch lines to shortline operators, we are continuing to reinvest in our property and are in the process of acquiring the MKT Railroad. We presently have 1,200 miles of marginal lines in Idaho, Louisiana, Arkansas and other states on our system out for bids from prospective purchasers. We think we will be successful in selling much of this trackage instead of having to abandon it. These sales will benefit local communities and shippers by ensuring continued rail service. Our railroad also benefits from selling rather than abandoning trackage since we can still participate in traffic coming off these lines. We have about another 1,800 miles of trackage system-wide that at some point could be put up for sale.

Our purchase of the Missouri-Kansas-Texas Railroad is motivated by financial and operating considerations. By using a combination of Union Pacific and Katy track, we will be able to significantly improve our service between Kansas City and Houston and reduce route mileage between Salina, Kansas, in the middle of the grain belt, and Fort Worth.

Union Pacific is also concerned about Katy's financial condition given the fact that we operate over 350 miles of Katy trackage on our Kansas City to Texas route. Although the MKT is not bankrupt, it is clearly a marginal railroad. Union Pacific has been funding capital projects for the Katy lines over which we operate and we're growing increasingly reluctant to put money into a property we do not own. We are also concerned that our investment in this track is at risk because Katy's maintenance of way budget is inadequate.

We are paying $110 million in cash for the MKT. However, we are also assuming $250 million of long-term debt, incurring labor protection estimated at $70 million, and planning to spend over $70 million for upgrading and construction on Katy lines. Consequently, the total cost will come to almost $500 million.

PROBABLE IMPACTS OF LEGISLATION TO REREGULATE

Spokesmen for the CURE group and the Procompetitive Rail Steering Committee, which together make up the new Coalition for Rail Fairness and Competition, contend that their legislative proposal would not reregulate the railroads. They assert that their bill would only affect captive shippers who have not been afforded protection from unreasonable rates by the ICC. No change would be made, they say, to Staggers Act provisions applicable to "competitive" traffic.

The Coalition's arguments are correct in one sense. The CURE bill would not entirely return the rail industry to the system of regulation that prevailed prior to the Staggers Act. What it would really do is leave in place those provisions of the Act, such as contract ratemaking, that the CURE shippers support, but repeal or restrictively modify provisions of Staggers and the Interstate Commerce Act that are less to their liking. CURE has never proposed, for instance, a complete return to the pre-Staggers Act days, which would allow the railroads to once more set rates collectively.

In other than this sense, CURE's contentions are false. The CURE bill would affect far more than just "captive" shippers, even as CURE defines the term. *All* traffic, for instance, would be subject to the competitive access provisions of the bill. A shipper could be paying a rate of 120% of variable costs yet would still be entitled to reciprocal switching or terminal trackage rights upon request, since the CURE bill would mandate both where necessary to provide "alternative" competitive service. Railroads would also be required to provide "competitive" joint or proportional rates without regard to competitive circumstances.

Nor would the bill's proposal to end certification of State standards and procedures as being in compliance with Federal law affect only "captive" intrastate rail traffic. It would affect all intrastate rail traffic. And what about abandonments and labor protection? We believe that the changes on these two matters that were considered by the Subcommittee in the last Congress would harm all rail shippers, whether highly dependent on the railroads or not, since they would increase our costs of doing business.

The CURE bill would have a severe impact on the health of Union Pacific and the other railroads. Mandatory proportional or joint rates, reciprocal switching and joint use of terminals would drive rates to unreasonably *low* levels. Carriers could never earn revenues sufficient to sustain adequate plant investment and some of the marginal railroads would be driven into bankruptcy.

The dramatic competitive access changes advocated by CURE do not go to the issue of proper ICC regulation of maximum rates, which CURE has said over and over again is the reason for its legislative efforts. The question posed by the open access proposal is not "how high is too high" but "how low can we go".

Other sections of the bill are aimed more directly at maximum rate regulation. One provision would change the manner in which market dominance is determined to bring more rail traffic within Commission purview. A shift in the burden of proof as to rate reasonableness and new standards which de-emphasize revenue adequacy would force rates down sharply. The rate ceiling could end up at or only slightly above the 180% revenue/variable cost ratio that today serves as the threshold for ICC rate review.

Because of our need to differentially price traffic in line with the demands of the marketplace and competition, we would have to try to make up revenues lost through forced rate reductions by raising rates on our remaining traffic. We would lose traffic to truck and water competitors in the process and be forced to again adjust rates upward to recoup revenues. Over the longer term, Union Pacific and the other railroads would become totally dependent on bulk traffic and the remaining rail shippers would pay their "stand-alone" costs for rail service.

The railroads are a healthier industry today than in 1980 but our capital investment continues to exceed our earnings. The message I want to leave with you is that we are not strong enough to withstand the effects of the CURE bill or other measures that would increase ICC regulation. Beyond this, we need to work with you and with rail labor to achieve solutions to the pressing problems facing us, such as the Railroad Retirement system and the Federal Employer's Liability Act.

While you may think Union Pacific Railroad's 1986 earnings of $385 million are extremely healthy, our return on investment is still inadequate. I should point out too that a good portion of our cost savings last year—$150 million—came from fuel savings. The fact that Union Pacific's earnings improvements are all coming from cost savings demonstrates that the Staggers Act has not allowed the railroads to significantly increase their profits. It demonstrates the pervasiveness of competition today, both intramodal and intermodal, and the challenges that lie ahead.

Thank you. I would be happy to try to respond to any questions you have.

Union Pacific Corporation,
New York, NY, July 17, 1987.

Hon. Ernest F. Hollings,
Chairman, Committee on Commerce, Science, and Transportation, U.S. Senate, Washington, DC.

Dear Mr. Chairman. Attached are my responses to the questions you forwarded to me from Senator Rockefeller in connection with my testimony before the Surface Transportation Subcommittee of the Senate Commerce, Science, and Transportation Committee on June 17th.

Very truly yours,

Drew Lewis,
President.

Q1. In your appearance before the Committee, you said "if you are upset with the ICC, give some more regulation to them, give them some more power, give them more regulation, but do not give us more problems." You reject the CURE bill and seem to have another suggestion for us. What, precisely, is your suggestion that is indicated by your above quote.

A. The principal complaints now being made about the Staggers Act are the amount of time the Commission has taken to adjudicate rate cases and the tendency the Commission has to move on a case only when Congress threatens to advance legislation that would pare back Staggers Act freedoms. My suggestion is that if these are the problems, then these are the issues Congress should address—perhaps by forcing the ICC to set administrative deadlines for final decisions on rate matters or through stricter budgetary discipline. But do not punish the railroads with the CURE bill if you think that there is a problem at the ICC. Staggers should not be rolled back because Congress is upset with some of the practices of the agency charged with enforcing the legislation.

Q2. Since you testified no one has filed a rate complaint against you since the Staggers Act and you said you work out all your problems with your shippers, why do you oppose the captive shipper and competitive access provisions of the Consumer Rail Equity Act?

A. We see the CURE bill as an attempt to force rail rates down to unreasonably *low* levels through a combination of very restrictive ICC rate regulation and forced trackage rights and switching. The fact that Union Pacific works with our shippers to negotiate rate and service arrangements and to resolve problems does not mean, as implied by your question, that we would be unaffected by the CURE bill. We would be seriously harmed by the bill.

The captive shipper provisions of the CURE proposal would substantially increase the amount of traffic subject to maximum rate regulation by the ICC and effectively convert the jurisdictional threshold for ICC rate review from a rate floor to a rate ceiling. The competitive access provisions of the bill would force rates down even on traffic that is already highly competitive and which bears rates well below the jurisdictional threshold. Beyond this, the bill would foster an adversarial relationship between carriers and shippers since, rather than discussing problems and negotiating with each other, both sides would look to the ICC to make decisions.

Q3. You said that you would meet personally with any captive shipper who has a complaint against the UP and "at the point, if they object to what we are doing, let them go to the ICC and complain." Isn't that the crux of the captive shipper complaint? Your analysis assumes that there is an effective remedy available at the ICC for those with a genuine grievance. If that remedy is not available, then your analysis does not provide a workable answer, does it?

A. There is an effective remedy at the ICC. In recent major rate decisions, the Commission has come down on the side of the shipper. The Commission's guidelines for maximum rates on coal and on other commodities are proving to be beneficial for the shippers. The preceived lack of adequate protection for rail shippers at the ICC arose largely because of the extended period of time cases remained pending while the Commission was struggling to come up with rate guidelines that would withstand judicial scrutiny. Now that the guidelines are in place, the Commission is moving expeditiously to complete action on longstanding cases and to design special procedures for small shippers.

My point in making the statement cited above was not just to say that shippers are entitled to a regulatory remedy where the railroad and the shipper cannot agree. It was to emphasize that a preferred course of action should be for the shipper to work with the railroad and that if agreement *can* be reached, then the shipper should not go the Commission. I think that many of the shipper interests supporting the CURE bill are doing so not because they have a beef with the railroads but because they feel they can obtain even lower rates if the CURE bill is adopted.

Q4. When you quote a discount rate with a shipper, do you provide the shipper with your estimate of the revenue to variable cost ratio of the rate? Would you provide that information to a shipper who asked for it?

A. Revenue to variable cost ratios are a regulatory tool. We do not develop a revenue-variable cost ratio when negotiating contract rates and do not provide such a ratio to the shipper. Cost information is highly confidential. While during the course of contract negotiations we may be willing to share certain information about revenues and costs with the shipper, we would be strongly opposed to make such information public.

Senator ROCKEFELLER. Thank you, sir.

Mr. McKinnon.

Mr. MCKINNON. Thank you, Mr. Chairman. I have submitted a written statement. I also am familiar with the statement that Mr. Dempsey of the Association of American Railroads presented, I believe it was last week, detailing problems of the industry, and I subscribe to the statement he has there. It is applicable to our company as well as to the other companies in the industry.

I have a few brief remarks today that I think perhaps may go more directly to some of the points about which you have been concerned.

As a former chief traffic officer of Norfolk Southern, it surprises me that even a minority of rail customers want changes in the Staggers Act. The act, together with trucking deregulation and with the economic trends in the country over the last several years, has made the rail business more competitive today than it has been at any time during the 35-plus years I have been in the industry.

As a result, rail service has improved, and rail rates in real terms have fallen dramatically for all kinds of traffic. Far from having lost out on these changes, customers for coal transportation, which is obviously of vital concern to you, have been a particular beneficiary of them. On our own system, our average revenue per ton of coal in constant dollars fell 21.4 percent from 1982 to 1986. In fact, average revenue per ton of coal fell even before adjustment for inflation.

Let me give you an example, Senator, of how this comes about. Norfolk Southern is always trying to move more coal. If we do not move coal, we do not make money. A Virginia utility served by CSX came to Norfolk Southern and asked for a special reduced rate so that Norfolk Southern could handle the coal to Tidewater, where it could then be barged to the utility which did not have Norfolk Southern rail service.

Norfolk Southern worked out a contract with the utility, cut its rate substantially and got the business. Then CSX looked back at what had happened. They cut their rate still more and recaptured the business. So the coal in short order enjoyed two rate reductions. The marketplace was allowed to work.

Now, as it happened, the utility, which pays the freight bills in virtually all of these cases, moved the coal from so-called captive shippers; that is, shippers local to Norfolk Southern during the period it used the reduced Norfolk Southern rate. Competitive forces reduced the rate this coal was paying for reasons completely unrelated to its captive status.

This is not a special case. It is typical of how coal markets work under Staggers. Our customers play Norfolk Southern against CSX and both against other sources. These customers negotiate for the lowest possible rates often on all coal moved from a particular territory. It may or may not be captive.

At the time we make the contract, we may not even know what lines the customer will choose to use to fulfill the contract because the customer, as I said, in these cases, the utility cases I was mentioning and in almost all of the other cases we have, the customer, the person paying the freight bill, is the receiver who is negotiating with us and is also negotiating with the coal producers, both large and small.

Both we and those coal producers are captive for that customer. This is the kind of price competition which railroad customers enjoy under Staggers. Norfolk Southern has suffered declining yields across almost the whole spectrum of our traffic and in many cases declining volumes as well, resulting, among other things, from the intense truck competition, weakness in the smokestack industries, and the Nation's difficulties in competing in international markets.

Consequently, our income from rail operations has been declining; from rail operations, Senator. It fell over 30 percent between 1981 and 1986. Net income for Norfolk Southern Corporation, the parent company, has increased in recent years only because increases in nonrail income have been greater than decreases in rail income.

Norfolk Southern is committed to transportation. We have done everything possible to emphasize that business. In recent years we have invested in capital improvements every year an amount greater than our entire net income from both rail and nonrail sources. We have been accused by some of being stupid for doing that, but, like Mr. Lewis, we are in the business. We have to take what we have there. It has taken more capital investment than our income to do that.

From 1981 to 1986, we put over $3 billion in capital improvements into the property while, as I noted, our rail income was falling over 30 percent. Our rate of return on rail business continues to be less than the cost of capital, and that cost of capital is the determinant in the marketplace as to whether people invest in us, lend us money or stay with us as a company. So we have to be meeting that cost of capital at some point or we will be out of business.

This situation ought to worry everyone with an interest in rail transportation as much as it worries us at Norfolk Southern. The unavoidable message from these numbers is that our rail plant is not supporting itself. All the furor over revenue adequacy comes down to the simple fact that our rail properties are not generating enough income to survive in their present form in the long run.

Selective rate reregulation which is explicitly designed to reduce rates on bulk commodities like coal will make the numbers worse. As returns fell, we would be forced drastically to contract our plan. Although high density corridors would stay in place, as peripheral traffic was lost its contribution to fixed costs would have to be taken over by the remaining customers, such as coal.

These customers, who depend the most on rail transportation, have the most to lose from changes which will determine the viability of our rail operations.

Thank you, Senators.

[The statement and questions and answers follow:]

STATEMENT OF ARNOLD B. MCKINNON, CHAIRMAN, NORFOLK SOUTHERN CORPORATION

My name is Arnold B. McKinnon and I am Chairman, President, and Chief Executive Officer of Norfolk Southern Corporation. Norfolk Southern is a holding company which owns and operates the Norfolk and Western and Southern railways, as well as North American Van Lines, one of the nation's premier motor carriers. Our rail system is comprised of 17,500 route miles serving 20 states, primarily in the Southeast and Midwest. It consistently ranks among the most profitable and efficient in the country.

Had Norfolk Southern been involved only in the railroad business in recent years, its financial results would have been far less impressive. Although our rail operations are more efficient than most and although we put over $3 billion in capital improvements into the property between 1981 and 1986, a decreasing proportion of our net income is attributable to rail operations.

Our total net income has gone up, and in that sense Norfolk Southern as a whole is a prosperous and successful corporation. But total net income has gone up only because non-rail items have increased faster than the rail component has declined. From a high in 1981, the rail component of our net income had fallen approximately 22% by 1985 and fell again almost 12% between 1985 and 1986.

The decline in our rail income is in part due to lower rates under Staggers and in part due to less traffic. One of the reasons Norfolk Southern tried to buy Conrail was the need to put rail operations on a sounder footing. Two years ago (February 27, 1985), Norfolk Southern testified before the full Committee here that the present trend "is dangerous for Conrail . . . dangerous for Norfolk Southern, and . . . dangerous for the private rail sector in the Northeast."

The reason it is dangerous is that a company cannot justify reinvestment in properties which are not earning an adequate return. Imposition of selective rate regulation designed to reduce our rail income still further can only result in the deterioration of the rail system. Even now it is hard to justify the annual capital investments our system could use. Capital investment on Norfolk Southern fell from $739 million in 1985 to $698 million in 1986, and will fall again in 1987. Every year we are putting more into the property than our entire net income from both rail and nonrail sources.

Selective reregulation of bulk commodity rates will hurt all our customers. If we try to make up the shortfall from other customers who contribute less than bulk commodity shippers to fixed costs, we will drive those other customers away and leave a still larger share of fixed costs to be borne by, for example, coal. You cannot rob Peter to pay Paul. All you can do is cannibalize the railroad to transfer a little temporary benefit to the shippers who most depend on the railroad.

By cannibalizing, I mean using up while removing the incentive and ability to replace. In the case of Norfolk Southern, we are talking about almost $10 billion in assets, including approximately $7.4 billion in transportation properties.

These assets are there for the benefit of our customers. Our customers must pay for them. If this investment cannot earn a competitive return in transportation, it will go somewhere where it can. This is not a matter of choice with Norfolk Southern. If we elected to ignore the need for a competitive return, we could not survive as a corporation. Our rate of return on rail operations, 8%-9% by ICC calculations and less under other methods, is not enough to pay for the capital those operations require. The whole controversy over revenue adequacy and revenue adequacy methodology is almost beside the point in the face of the plain fact that rail operations do not produce a sufficient return.

The effort to drive down rail rates through legislation comes primarily from coal interests such as utilities. This is ironic because coal rates have fallen dramaticially under Staggers and in the face of market pressures. In real terms, our average revenue per ton of coal fell 21.4% from 1982 to 1986.

The great preponderance of our coal is Appalachian coal from Virginia, West Virginia, and Kentucky, as the attached table shows. This 21.4% decrease is fully reflected by the rates paid on coal moving from these states.

Our rates have not gone down because we wanted them to; they have gone down because to move coal we have to respond to the market. Coal is our most important single commodity group. Our coal, coke and iron ore revenues provided 41.5% of revenue ton miles (though only 34.2% of total revenues) in 1986. We prosper most when the most coal moves. Accordingly, we make rates to try to maximize the overall long run movement of coal.

The idea that small "captive" shippers are gouged by Norfolk Southern lacks any foundation. The fact is that almost all the people who purchase transportation of coal from Norfolk Southern are utilities, transshippers, or other large parties in no way limited to any single source, "captive" or otherwise, for their supply of coal. They are far from captive. They know how to play Norfolk Southern off against CSX and both against other sources.

These big buyers may get their coal from "captive" mines or other mines or both. We don't even necessarily know where the coal to fill a given contract will come from. Contracts and tariffs for tidewater coal normally specify charges based on the general geographical origin of the coal—its district or group in railroad terms—but certainly not on its status as "captive" or not. There is generally no requirement for trainload movement from a mine to qualify for the rate.

The big utilities and other users of domestic coal similarly get rates which are good from multiple origins unless they request a limitation to specific origins.

So with respect to coal the "captive shipper" problem is largely illusory: in truth, the parties who purchase transportation are most often big utilities and transshippers with many alternative sources and very substantial negotiating leverage. They can draw coal from either "captive" or other sources without affecting the rate.

In summary, Norfolk Southern is giving its customers excellent service at falling real prices with a multi-billion dollar plant which costs hundreds of millions of dollars a year to keep up The great threat on the horizon for these customers has nothing to do with any alleged problems under the Staggers Act. The threat is that our rail plant is simply not earning enough to be self-sustaining over the long term. Arguments over how you calculate rate of return and cost of capital are important but not ultimatly determinative. We can't put money into the railroads indefinitely unless we earn a better return.

That is why selective reregulation would be so utterly improvident and self-defeating. It would have the express purpose of further reducing already inadequate rates of return, and so undermine service to those customers who most depend on the railroad.

NORFOLK SOUTHERN COAL—1986

(Million of tons)

Originated:	
Appalachian:	
Virginia	42.6
West Virginia	25.6
Kentucky	18.4
Alabama	11.8
Tennessee	3.6
Total Appalachian	102.0
Illinois	3.8
Ohio	2.2
Indiana	2.1
Other	0.6
Total originated	110.7
Received:	6.8
Total	117.5

NS NORFOLK
SOUTHERN

Norfolk Southern Corporation
One Commercial Place
Norfolk, Virginia 23510-2191
804 629-2610

Arnold B. McKinnon
Chairman, President and
Chief Executive Officer

July 17, 1987

The Honorable Ernest F. Hollings
Chairman, Committee on Commerce,
Science, and Transportation
United States Senate
Washington, D.C. 20510-6125

Dear Senator Hollings:

Enclosed are answers to the questions submitted with your letter of July 2. The questions and answers supplement the Surface Transportation Subcommittee's hearings on June 9, 17, and 24 concerning the rail industry and the implementation of the Staggers Act. Five sets are provided as requested.

I wish to thank all the members of the Subcommittee for the courtesy and attention extended to Norfolk Southern during the hearings.

Sincerely,

Arnold B. McKinnon

Enclosure

Operating Subsidiaries: Norfolk and Western Railway Company / Southern Railway Company / North American Van Lines, Inc.

1. You said your average revenue per ton mile [actually, "per ton"] of coal in approximate [actually, "constant"] dollars fell 21.4 percent from 1982 to 1986. In fact average revenue per ton of coal fell even before adjustment for inflation. What are the comparable figures for 1980 to 1982 and 1980 to 1986?

Answer

The following table provides the detailed 1982-1986 data. Because Norfolk Southern did not come into existence until 1982, we do not have fully comparable data for 1980-1981. However, we estimate that the percentage decrease in average revenue per ton of coal in constant dollars was about the same (i.e., over 20%) whether measured 1980-1986 or 1982-1986. In other words, rate increases during the coal boom of the early 1980's were approximately proportional to inflation, so the constant dollar rate rose only slightly from 1980-1982 and thereafter fell dramatically.

Year	Avg Coal Rev/Ton	Avg Coal Rev/Ton (1982 Dollars)	Index
1982	$10.12	$10.12	100.0
1983	9.70	9.33	92.2
1984	9.54	8.78	86.8
1985	9.72	8.60	84.9
1986(est.)	9.31	7.97	78.6

1. (question cont.) The testimony of the AAR, with which you associated yourself, was that rail productivity across the board increased 39% during this period. Coal, which is handled by unit trains, undoubtedly enjoyed an even greater productivity gain. Thus, since your productivity increased more greatly than your revenues fell, your profitability on coal must have increased since 1982. How much has the profitability of your coal haulage increased since 1982?

Answer

Although rail transportation productivity for all U.S. Class 1 railroads may have increased 39% since 1980, the movement of coal on Norfolk Southern has not enjoyed a comparable productivity increase. The improvement in national rail productivity has resulted in large part from factors (such as a reduction in box car and other under-contributing traffic and associated reductions in employment) which have not markedly affected the productivity of coal movement on Norfolk Southern. On Norfolk Southern, coal continues to be handled primarily in solid blocks (not necessarily unit trains) in much the way it was in 1982.

Specifically, except for a small increase in labor productivity in the last year, productivity for handling coal over the last six years has not changed significantly on Norfolk Southern. On the one hand, there has been a reduction in utilization of our hopper fleet as the level of export coal movements dropped off from its peak in the early eighties. On the other hand, the productivity of the locomotive fleet has been improved through expenditure of over $300 million on new high technology locomotives.

When all this is balanced out and cost increases as well as changes in physical productivity are considered, it is probably accurate to say that Norfolk Southern earns less from coal haulage in 1987 than it did in 1982. The reason is simple. Coal rates on average are lower than they were in 1982, while unit labor costs, which comprise approximately 50% of all Norfolk Southern's costs, have increased 23% over that period.

2. You say net income for Norfolk Southern Corporation, the parent company, has increased in recent years only because increases in non-rail income have been greater than decreases in rail income. Please document, providing details on depreciation.

Answer

	1984	1985 (millions)	1986
Net income - rail operations only	$376.3	$372.3	$328.3
Net income as reported	$482.2	$500.2	$518.7
Capital expenditures	$473.6	$738.6	$698.4
Depreciation			
Rail	$243.1	$243.9	$258.6
Non-rail	$ 2.1	$ 10.3*	$ 22.3*
Excess of capital expenditures over depreciation	$228.4	$484.4	$417.5

*Increase due principally to inclusion of North American Van Lines

3. Please provide your coal transportation's contribution to your overall rail operation profit (not revenue) for each year since 1981.

Answer

Norfolk Southern does not have any breakdown of its rail net income ("profit") by commodity. Any such breakdown would depend on debateable assumptions, particularly as to the proportion of fixed costs to be charged to each commodity. When it needs to make a pricing or management decision with respect to a movement, Norfolk Southern calculates the revenue-to-variable-cost ratio of the movement. This indicates how much the movement may contribute to fixed costs, but not how much it may contribute to net income.

As indicated in the answer to the first question, it appears that coal made a smaller contribution in 1986 than in 1981 or 1982.

4. You make much of the fact that there is distinction and competition in the export coal market, thus, you have no power to gouge the coal producers who are exclusively served by your railroad and who are trying to compete in the export coal market. Isn't that exactly the theory that the railroads and ICC used in the export coal exemption case. Didn't the Court of Appeals strike down the ICC action and reject that theory because it completely disregards the market power you have to dictate the division of the delivered price of the coal between you and the coal producer who is exclusively served by you?

Answer

The ICC and the petitioning railroads argued that the market for export coal is world-wide and highly competitive. Based on its findings as to competition and the history of rail export coal pricing, the ICC concluded that the railroads would not price their services in such a way as to affect adversely the position of U.S. coal producers in the world market. The Court of Appeals vacated and remanded the ICC's exemption order. It did not hold that railroads could "dictate the division of the delivered price between [the railroad] and the coal producer," but rather that the ICC had failed to give adequate consideration to that issue in construing the statutory tests for granting exemptions and had failed to explain or justify adequately the standards for applying those tests. While the Court of Apppeals concluded that the ICC misconstrued the market power tests, Norfolk Southern's experience in the export coal market continues to reflect intense competition supporting the ICC's conclusions.

5. When you quote a discount rate with a shipper, do you provide the shipper with your estimate of the revenue to variable cost ratio of the rate? Would you provide that information to a shipper who asked for it?

Answer

No. This is confidential and commercially sensitive information.

In fact, in a typical situation where NS and its coal customers negotiate rates, the question is not usually the margin of profit in the rail rate, but what rate it will take to put or keep the customer's coal in a given market at a competitive delivered price. In the increasingly competitive coal environment, rates are continually being reduced to prevent loss of the market to other carriers or to mines in other countries.

Senator ROCKEFELLER. Thank you, Mr. McKinnon.

Mr. Gaskins.

Mr. GASKINS. Yes, I would like to submit my statement for the record and just address myself to some of the concerns that have been expressed by the panel today.

One of the comments that I would make goes along with what Mr. McKinnon said on revenue adequacy. The issue of revenue adequacy is really a question of how much of our railroad do we replace.

Our railroad is in a lightly populated part of the country, so we do not enjoy a strong traffic base which some other railroads have in this country, and it has led us to move dramatically to restructure or rationalize our system. We have already abandoned over 5,000 miles of line since the Staggers Act was passed.

This year, we have sold four branch lines to enterpreneurs to try to hold on to the rail service, and we are in the process of consummating five more deals as we speak here today. We are doing this because we recognize we can no longer afford to maintain the full railroad that we have in our territory. Furthermore, everything that is done to lower our rates to particular shippers, whether they be coal shippers or grain shippers or whoever or to further restrict our activities just means that in the long run we will operate less railroad.

We are not revenue adequate, and that means we cannot afford to replace the whole plant that we have in place today. Quite frankly, the issue before us is how much of that plant will we be able to maintain over the long term?

We would like to stay in the railroad business. We would like to stay in all those states that we serve. We are a vital part of those states. In fact, we helped build them, but our long run future is really in jeopardy as I see it today.

I also would like to comment on this concern about whether or not the Commission has done anything with respect to maximum rate cases. I guess that is the primary reason why I am here today, because the Burlington Northern, for whatever reason, is the guinea pig. We have been hammered by three adverse coal decisions in the last 18 months which have cost our company $150 million, and that is $150 million which is hard to come by in the competitive environment which we face today. Those cases include the San Antonio case, the Omaha Public Power District case, and the Arkansas Power and Light case.

In addition to that, we are the party that has been, I think, dealt fairly harshly with respect to the McCarty Farms case. Only time will tell as to what the dollar penalties will be in that particular situation.

Interestingly enough, having lost all three of those cases, and it looks like we will lose the McCarty Farm case, we have no rate cases left. The Senator from West Virginia was asking before why have you no rate cases left? The reason we have no rate cases left is that competition has served to lower our rates in most instances, and in one particular instance competition has changed the whole landscape. That is in the Powder River Basin.

We originated in 1984 in the Powder River Basin over 145 million tons of coal, and the Commission, in the public interest I presume, allowed entry into that basin by a competitive railroad system. Since that time, proceedings before the Commission are irrelevant.

We are in a dogfight. My good friend to the left of the table there knows a lot about it. Competition is controlling the rates out of that basin. I promise you there will be no more coal rate cases in my lifetime in the Powder River Basin because those rates are being controlled by competition between the Burlington Northern and a combination of the Union Pacific and Chicago Northwestern. There will be no more rate cases because there has been entry into that particular market.

I also would like to comment on rate levels. I will give you some average numbers that do not represent in any particular case what the rate levels are, and then I will give you a couple of numbers that relate to Senator Exon's concerns about grain rates.

On our railroad between 1982 and 1986, average coal rates came down 7 percent, and I am not talking "real" terms. I am talking about decreases that have not been adjusted for inflation. If we adjusted them for inflation, the decreases would be even greater. In 1987, our rates are down even lower, but I do not have the figures for the current level.

Overall, our rates came down over 14 percent, and grain rates in particular came down a whole lot more than that. In terms of grain rates, let me give you a couple specifics.

Before the Staggers Act was passed, we moved a fair amount of corn from Lincoln, Nebraska to the Gulf of Mexico. The single car rates, which were the only rates that were relevant in that time period, were $1.75 per hundred weight. Today's rate moving in a unit train is $.86. Those rates were lowered by 50 percent in the ensuing seven years.

Corn to the Pacific Northwest from the same origin, Lincoln, Nebraska, pre-Staggers in a unit train the rate was $1.225. Today's rate is $.85 for a 31 cent reduction.

For wheat to the Gulf, it is the same story. The single car rate before the Staggers Act was $1.66. The unit train rate today is $1.02 or 39 cents below the pre-Staggers level.

This has happened across the board in the grain business. Competition has driven those rates down. In fact, it is really interesting. In the famous McCarty Farm case, the Commission has decided that because we lowered the rates and increased our share of the market vis-a-vis the trucks and barges in the State of Montana, we are a market dominant railroad.

I guess the conclusion is that if you lower your rates, you get hammered, too. Of course, now it is irrelevant because we have no more rate cases before the Commission because competition is controlling the rates we have at the present time.

In terms of what the Staggers Act has done to us financially, it is in our statement, but let me reiterate. 1984 was a high water mark for the Burlington Northern Railroad. We earned $528 million in that year. Since that time, we have seen steady, dramatic erosion in our profitability. In 1985, our earnings dropped to $454 million. Last year, we earned $226 million. And quite frankly, we will be very fortunate to earn that much in 1987 on the railroad.

And the reason is that we are facing a very, very competitive world. Now, in that same time period every year we have invested more money in our railroad than we earned. But we have begun to draw down that investment very rapidly. At the high water point in 1985, we invested about $650 million in the railroad. This past year we invested about $351 million.

This year we are going to invest less than $300 million in our railroad. And quite frankly, Senator, if we do not get some relief, if the economic conditions do not improve for our industry, we are going to invest a whole lot less in the rail industry in the years ahead.

Rather than talking about passing the CURE Act, I think it would be more appropriate if the Congress of the United States spent their time trying to relieve us from some of our burdens, such as secondary picketing, railroad retirement, and a very unfair workman's compensation program. We need a lot of help.

Thank you very much.

[The statement and questions and answers follow:]

STATEMENT OF DARIUS W. GASKINS, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, BURLINGTON NORTHERN RAILROAD COMPANY

Mr. Chairman and members of the Subcommitee, I am Darius W. Gaskins, Jr., President and Chief Executive Officer of Burlington Northern Railroad Company. I appreciate the opportunity to comment on the financial condition of the Burlington Northern, the challenges we face, and the implementation and proposed amendment of the Staggers Rail Act of 1980. I hope my comments today will be helpful in conveying one message to you: the railroad industry is not healthy and the only way to alter this situation is for Congress to change the laws to treat us like every other industry in the United States.

FINANCIAL CONDITION

One of the primary purposes of the Staggers Act was to improve the financial condition of the railroad industry. At the time, few disputed the need for some form of legislation. Twenty-two percent of the railroad system was in bankruptcy; the railroad industry's return on investment was less than two percent; and service frequently was unreliable. The Staggers Act has benefitted Burlington Northern and its customers in many ways, especially by making it easier for use to meet competition through individual shipper contracts and various exemptions. The Staggers Act has not, however, greatly improved our financial condition, in part because of new railroad competition it brought to the Powder River Basin and elsewhere.

In the Subcommittee's last hearing, it was suggested by one witness that in order to get a true picture of the health of the railroad industry, the Subcommittee ought to examine the financial performance of Burlington Northern and the Norfolk Southern. I welcome such an examination; however, I do not believe it will yield the results intended by the previous witness.

I, of course, would be the first to agree that Burlington Northern is doing better financially than many of the other members of the railroad industry. However, to take two of the top performers in the railroad industry and say that our financial condition is indicative of the industry as a whole hardly paints a true picture. Moreover, for me to agree that Burlington Northern is doing better than many other railroads, is certainly no admission that Burlington Northern is "the picture of excellent financial health." Burlington Northern is doing better than some railroads, but that is not saying much. Similarly, the railroad industry is doing better, but it still ranks near the bottom of major industrial sectors.

Some specific financial data should help illustrate my point, Burlington Northern's net operating income in 1983 was $383 million; in 1984 it was $528 million; in 1985 it was $454 million; and in 1986 it was $226 million excluding $500 million in write-offs and special changes. 1984 was a peak year for us because it was a big grain year and it was the last year before the introduction of railroad competition into the Powder River Basin. Since 1984, our traffic, freight revenues, and net operating income all have declined. Furthermore, at this point I see nothing on the horizon to indicate that this trend will change.

You undoubtedly have heard before that the railroad industry is a capital intensive business. In Burlington Northern's case, our investment in plant and equipment in 1983 was $552 million; in 1984 it was $611 million; in 1985 it was $651 million; and in 1986 it was $351 million. What you may not have heard before is that capital expenses are computed after net income and not before. The significance of this, and what is illustrated by these numbers, is that Burlington Northern's capital expenses have greatly exceeded our net income since 1983. In fact, our capital expenses have exceeded our net income by a total of nearly $1 billion during this period!

To help pay for these capital expenses, we have taken advantage of every means available to us. First, we have cut costs, which is a matter I would like to come back to momentarily. Second, we have made good use of the provisions of the Economic Recovery Act of 1981. This Act allowed us to depreciate new track and equipment on an accelerated basis (five years) and to write off pre-1981 purchases that previously had been treated as expenses. Unfortunately, the benefits of the Act now have been exhausted. Furthermore, it has been replaced by the Tax Reform Act of 1986, which eliminated investment tax credits and other incentives for new capital investment.

One thing we have not done is to increase rates to our shippers. The reason is that we simply cannot. In fact, due to intense competition, individual rates either have decreased or increased only enough to keep up with inflation. Specifically, since 1982, our grain rates have decreased approximately 55 percent and our coal rates have decreased 7 percent. The average of all our rates has decreased 14 percent.

Due primarily to cost cuts and tax write-offs, Burlington Northern has been able to register profits even though our net operating income was down and our capital expenses holding steady. However, the rates of return on our investment have been modest. In 1984, our rate of return on invested capital was 9.4 percent. In 1985, it declined to 8.1 percent and in 1986 it fell another one-third to 6.5 percent. I do not believe these rates of return are nearly as high as Congress envisoned when you passed the Staggers Act nor do I believe they are sufficient to attract the capital necessary to maintain and improve Burlington Northern's railroad system in the future.

COST REDUCTIONS

Because fierce competition has prevented Burlington Northern from increasing the rates we charge to shippers, we have been forced to be all the more aggressive in cutting costs in as many areas as possible. This has not been easy to do, especially where our employees have been involved. However, we simply have had no choice.

Since 1980, we have reduced employment on the railroad by 23,000. This has been accomplished by a combination of attrition, buyouts, and voluntary separations. As a result, we have reduced our annual costs by $1 billion. While these savings are significant, we need to reduce our labor costs even more. To help in this regard, we already have announced that we will not participate in the national rail labor agreement negotiations when the current agreement expires in 1988. Instead, we plan to go it alone and negotiate directly with the unions that represent Burlington Northern employees. In doing so, we want to see if we can get some things tailor-made for Burlington Northern, rather than something worked out by committee for the whole industry. We think this would be better for both Burlington Northern and its employees. Last week we met with the chairmen of our various unions to advise them of what we will propose in the 1988 negotiations. We also asked them to begin discussions in advance of the normal starting time.

We also have sought to reduce our costs by better managing our equipment. Last year, we entered into an Electrical Power Purchase Agreement under which we committed to purchase on a take or pay basis electrical power generated by locomotives owned or leased by a third party energy supplier. The supplier is responsible for the investment in and the maintenance of the locomotives. While this agreement is the first of its kind in the railroad industry, we expect more to follow. We also anticipate that it will result in cost savings to us, particularly when new suppliers start competing for the business.

Finally, we recently have sold some marginal rail lines as a means of reducing our costs. This year, we have completed four separate line sales involving 800 miles of track. The individual lines vary in size from 52 miles for the smallest to 370 miles for the largest. We expect to sell five more lines by the end of the year.

While I mention these line sales as a cost-cutting measure, they really involve much more than that. If you would permit me to digress for just a moment, I would like to describe briefly some of the other benefits of these line sales.

Our line sale program concentrates on marginal lines with either declining business or severe competitive pressures. In both situations, it is often only a matter of time until abandonment is the only remaining option. A good short line or regional operator can make a margin line a profitable one. This is due in large part to the fact that crew sizes are smaller and work rules more flexible. It also is because short line and regional operators can afford to spend more time with one customer and strive to meet his or her special needs. These operators generally are locally based and shippers develop loyalty to them.

A good example of what I am talking about is the sale last year of 148 miles of our line between Monett, Missouri and South Fort Smith, Arkansas to the Arkansas and Missouri Railroad. Due to mountainous terrain and the need to change train crews, the cost of operating this line was high for us. In addition, we faced stiff truck and rail competition. As a result, our traffic levels declined sharply between 1981 and 1985 when we finally put the line up for sale. When the Arkansas and Missouri took over the line, it hired two-thirds of our former employees. It now operates its trains with two-person crews and without traditional work rules. It has had a very active marketing program. As a result, it has increased the traffic on the line by 20 percent.

Preservation of the line in Missouri and others like it have created a winning situation for everyone involved. Line abandonments have been avoided; the lines continue to feed traffic to Burlington Northern; shippers keep rail service; jobs are preserved; and communities suffer no losses. However, there is one other point that must not be ignored. Without the Interstate Commerce Commission's decision not to impose labor protection in these transactions, most of these line sales would not have taken place. It is a matter of simple economics. If labor protection were imposed on either the buyer or the seller, the costs of the sales would be increased by amounts that would make the sales economically infeasible.

FUTURE CONCERNS AND CHALLENGES

Since 1980, Burlington Northern has done a lot to reduce our costs and improve our efficiency. However, we still have not done enough. Our labor costs are much too high and we have far too many rail lines. Of course, we will do as much as we can to address these concerns on our own in the future. The problem is that under current federal laws we simply cannot accomplish the sort of restructuring that is necessary to make us a truly viable and competitive business. To accomplish our goal, we need help from Congress in changing the laws governing labor protection, collective bargaining, railroad retirement, and compensation for unemployment and work-related injuries. We are not asking for special treatment. Instead, we are asking only that you treat us like every other business in the country.

The federal laws of which I speak were created in a bygone era. They were created at a time when the railroad industry dominated the transportation industry and the economy and when we employed five times as many employees as we do today. With few exceptions, they are not laws that Congress has seen fit to apply to other U.S. industries.

Labor Protection

In the hearing today, rail labor will propose legislation that would require the Interstate Commerce Commission to impose labor protection on sales of rail lines to new regional and short line operators. Under the current statute governing such line sales, the Interstate Commerce Commission has discretion with respect to imposing labor protection. As I mentioned earlier, the Interstate Commerce Commission has decided not to impose labor protection because it would render most sales economically infeasible. Congress should not only oppose the proposed expansion of this labor protection, you should consider eliminating labor protection altogether from other transactions subject to the Interstate Commerce Commission's jurisdiction.

Railroads are the only business in the United States now required by federal statute to pay labor protection to their employees when they sell, merge, or abandon their properties.

This labor protection includes the payment of up to six years of full waged and beneifits for any employee who loses his or her job or is bumped into a lower-paying position. Labor protection is provided on top of what an employee is entitled to be paid under Railroad Unemployment, which runs from 26 to 52 weeks. The combined costs of labor protection and unemployment insurance for Burlington Northern and the industry as a whole are enormous. In fact, the annual cost for the rail industry is estimated to be $700 million—equivalent to almost 40 percent of the industry's pretax net revenue from rail operations. These are costs that are not imposed on our competitors or on any other U.S. industries. Moreover, these are costs that we can ill afford to pay.

Furthermore, there is not justification for singling out railroad employees for job protection, especially when unemployment compensation is available to them. All of America has had to make adjustments as we have shifted from a smokestack economy to a service-oriented one and as foreign competition has been introduced in the country. Employees in the coal industry, the agricultural industry, the forest products industry, and the automobile industry have experienced severe dislocations as a result of sales, mergers, and plant closings. None of these dislocated employees have received six years of job protection from their employers pursuant to federal statute.

Secondary Boycotts

I said before that it is essential that Burlington Northern cut costs in order to meet our competition and maintain adequate earnings. We believe the best way to meet our goal is to bargain with our unions apart from the rest of the industry. However, we have one big problem. This year, the Supreme Court upheld the right of rail labor to engage in secondary picketing. This means that if we do not reach an agreement with our unions and they decide to strike, they can spread the strike from Burlington Northern to other railroads across the country. This is a potent club that could seriously undermine our efforts to achieve essential changes at the bargaining table. It also is unfair to the railroad industry. The use of secondary picketing has been prohibited for other industries since 1947 when Congress passed the Taft-Hartley Act. There is no rational reason singling out the railroad industry for special treatment in this area. Congress should amend the Rail Labor Act to prohibit secondary picketing.

Railroad Retirement

The Railroad Retirement System is a system that is unique to the railroad industry. It is a pay as you go system and consists of two tiers: "Tier I" is the railroad equivalent of social security and "Tier II" of a private pension plan. The System is plagued by problems: its costs are high; railroads like Burlington Northern are paying to support both their retirees and those of other railroads; and the ratio of workers to beneficiaries is bad and getting worse. The future solvency of the whole system is threatened. Let me take these points one at a time.

On the matter of current costs, the railroads now contribute 21.9 percent of taxable payroll to the Railroad Retirement Fund. For Burlington Northern, this amounts to $277 million a year. Our employees contribute another 11.4 percent of taxable payroll or $139 million—to produce a total of 33.3 percent of taxable payroll or $416 million annually being paid into the Fund. This is on top of what we provide for Railroad Unemployment and labor protection.

Second, because of past railroad failures, Burlington Northern is supporting both our retirees and those of these other railroads. To be specific, we pay 10.3 percent of the railroad retirement benefits while our retirees only constitute 7.8 percent of the total. While we fully recognize the obligation to support our own retirees, we are troubled by the fact that we are paying 25 percent over and above the amount of this obligation. I also would note that this situation creates an unfortunate incentive for railroads to retire additional employees so as to shift their retirement costs to competing carriers.

While I am concerned about the current situation, that concern pales in the face of my concerns about the future. Right now there are too few employees and railroads supporting the System, but the situation is only going to get worse as individual railroads, like Burlington Northern, attempt to reduce their workforces. Currently, less than 350,000 rail employees help support roughly one million retirees. This is a ratio of 1 to 3. Last June, the Railroad Retirement Board issued a report in which it projected negative balances in the Fund within the next ten to twenty, years, depending on employment trends. The Board estimated the unfunded actuarial deficit to be roughly $8.6 billion and recommended a 3 percent tax increase or benefit adjustment to achieve the same result, in order to avoid the impending deficit. Since the Board issued its report, employment has declined more sharply than projected.

It is clear that the future solvency of the System and its ability to pay full benefits to railroad retirees is in serious doubt. Moreover, it is apparent that a simple increase in payroll taxes will not achieve the long-term fix needed. Congress tried this in 1983 and again in 1985. Furthermore, the railroad industry with declining traffic and revenues and labor costs already accounting for almost 50 percent of our costs, simply cannot be asked to shoulder more costs and remain competitive in a deregulated environment.

A major change is required in order to put the Railroad Retirement System on sound financial footing. Unfortunately, none of us in the railroad industry have a solution to offer to you today. However, we would ask you to refrain from passing any immediate tax increases and instead work with labor and ourselves in exploring major structural changes to the existing system or preferably options for privatization.

Unemployment Compensation

The Railroad Unemployment program also is unique to the railroad industry. The program pays unemployment and sickness insurance and is the equivalent of state unemployment insurance systems. At with the Railroad Retirement System, declining railroad employment has created a serious problem for this program. The program is underfunded and for the last 20 out of 25 years has been in debt to the Retirement System. At present, this debt is around $800 million.

Last year, at the urging of key members of the House Energy and Commerce Committee, rail labor and management agreed to a proposal to address some of the immediate problems facing the unemployment program. Legislation encompassing the proposal died at the end of the Congress, but is being taken up again this year. This proposal represents another short-term fix. In the long term, it would appear to be in the best interest of both the railroad industry and our employees to go to state unemployment systems.

Compensation for Work-Related Injuries

Under the Federal Employers Liability Act (FELA), a railroad employee who is injured at work must sue to recover for medical expenses and lost wages. Like the other statutes I mentioned here today, this statute applies only to the railroad industry and is fraught with problems.

FELA is a fault-based system. The employee must prove that his or her injury was caused, in whole or in part, by the negligence of the railroad. In addition, the compensation paid may be reduced by the employee's own negligence. All claims must be resolved by negotiation or litigation. Furthermore, employees with similar injuries can, and often do, receive widely dissimilar compensation. For example, in three separate cases involving employees with leg amputations, a jury awarded $7 million in the first case, $1.8 million in the second, and nothing in the third case, which involved one of Burlington Northern's own employees.

FELA also is costly to the railroad industry. In 1986, the industry as a whole paid about $585 million in claims and Burlington Northern paid $68 million. Between 1979 and 1986, the industry's claims payout increased by nearly 100 percent. This was despite the fact that the total number of employees declined dramatically and that employee fatalities and injuries decreased.

The chief beneficiaries of FELA are the personal injury lawyers who reap large fees for prosecuting or defending these cases. State workers compensation programs, which did not exist at the time FELA was created, would serve railroad employees far better than FELA and would reduce the industry's high costs. For these reasons, Congress should repeal FELA.

INTERSTATE COMMERCE COMMISSION'S IMPLEMENTATION OF THE STAGGERS ACT

The proponents of S. 676, the "Consumer Rail Equity Act," argue that this legislation is necessary because the Interstate Commerce Commission has failed to implement the Staggers Act in a way that protects captive shippers and encourages competition. While these people do not think the Interstate Commerce Commission is taking its job seriously, Burlington Northern does.

Our view at Burlington Northern is based on firsthand experience. In the last fourteen months, the Interstate Commerce Commission has ordered us to pay shipper reparations in three separate coal cases. The first case was decided in April 1986 and involved a joint movement of coal by Burlington Northern and the Southern Pacific between the Powder River Basin and San Antonio, Texas. The case was divided into several parts. In the first part, the Interstate Commerce Commission ordered us to pay $40 million plus interest to the City of San Antonio. Subsequently, the whole case was settled for $111 million of which $82 million was paid by Burlington Northern.

In November, in a case involving the Omaha Public Power District, the Interstate Commerce Commission applied its coal rate guidelines for the first time and ordered us to pay $17.5 million plus interest. In May, the Interstate Commerce Commission, again found that some, but not all, of our contested rates with Arkansas Power and Light were unreasonable and ordered us to pay $21.8 million plus interest.

Furthermore, last month in the *McCarty Farms* case, the Interstate Commerce Commission determined that certain of our Montana wheat and barley shippers are captive and made tentative findings that the rates we are charging them are unreasonable.

For additional evidence that the Interstate Commerce Commission is taking its job seriously, I would bring to your attention a long list of recent rule changes that address shipper complaints. In 1984, the Interstate Commerce Commission initiated a proceeding to review its actions under the Staggers Act and to discuss those areas viewed as problems by shippers and railroads.

This proceeding was the impetus for shipper-railroad negotiations that in turn led to the Commission's adoption of two new rules in 1985 dealing with market dominance and competitive access determinations. Under the new market dominance rule, the burden of proving the effectiveness of product and geographic competition was shifed to the railroads. The competitiveness access rule substantially liberalized the conditions under which the Commission would grant competitive access to shippers and competing railroads, when requested. Also in 1985, the Interstate Commerce Commission substantially revised and clarified its proposed coal rate guidelines in response to shipper concerns. For example, the Commission eliminated the 15 percent annual ceiling on rate increases and provided instead for case-by-case consideration of the need for a phase-in period for rate increases.

In 1986, the Interstate Commerce Commission revised its rules dealing with boxcar traffic to establish special exclusionary and protective provisions for small railroads. It also revised its zone of rate flexibility procedures to provide for rate reductions when the rail cost index declines. It made major modifications in its approach to determining revenue adequacy, including the removal of deferred taxes from the investment base in calculating return on investment. Furthermore, it proposed changes in its contracts rate rules to provide for greater disclosure and discovery and proposed new maximum rate reasonableness guidelines for captive, non-coal shippers and for small shippers, including small coal shippers.

In view of this long list of pro-shipper decisions by the Interstate Commerce Commission, it is hard to believe that there is still room for complaint. If anyone should be complaining right now, it is Burlington Northern and the rest of the railroad industry. The only good thing I can say now is that once the *McCarty Farms* case is finally decided, we will have no more cases pending before the Commission. After the Staggers Act passed, the Interstate Commerce Commission received 232 complaints about our rates. Since then, with the exception of the four cases I just described, all of the rest have been settled. Furthermore, we have long-term contracts that govern 95 percent of our coal traffic, so we anticipate that few or no new coal rate cases will be filed in the near future.

PROPOSED AMENDMENTS TO THE STAGGERS ACT

The railroad industry is a troubled industry with numerous problems facing us now and in the future. The only bright light we have is the Staggers Act. While the Act has brought Burlington Northern challenges in the form of new railroad competition, it also has brought us opportunities. Most importantly, it has given us the ability to respond to competitive pressures and to adverse economic circumstances. The "Consumer Rail Equity Act" would seriously undermine the industry's ability to meet competition and to earn adequate revenues. This clearly is not in the best interest of our shippers, our employees, or our stockholders.

The primary purpose of the bill is to reduce the rates charged to captive coal shippers. To help achieve this purpose, the bill expands the Interstate Commerce Commission's jurisdiction over rates by prohibiting consideration of product and geographic competition. Further, it encourages the Interstate Commerce Commission to set rates at or close to 180 percent of variable costs by requiring it to consider whether and to what extent a rail carrier should be allowed to charge anything above that amount. It also shifts the burden of proving rate reasonableness to the rail carrier.

It has been estimated that if all captive shipper rates were reduced to 180 percent of variable costs, the railroad industry would be $77 million in the red. That may not be the worst of it. I have testified already that it is a competitive world out there and that Burlington Northern has been drastically cutting costs because we cannot raise rates. If the industry were forced to further reduce rates to captive shippers, we would have no choice but to cut our costs more than we already think necessary, in order to help make up for the revenue shortfall. This means more line sales and abandonments, further cuts in labor costs, and reductions in capital spending. Many of the industry's existing non-coal shippers and small shippers of all types simply would find themselves without rail service.

Other provisions in the bill also would adversely affect the industry's overall service and earnings. For example, the provision on inflation-based rate adjustments would require that productivity savings be passed on directly to shippers. Productivity savings now are supporting our capital investments and our earnings. Both would be adversely affected by this provision. The competitive access provision would force us to reduce our rates and charges or face the consequences of sharing our tracks and facilities with our competitors. Burlington Northern's experience in the Powder River Basin makes us acutely aware of what this provision could do to our revenue picture. The bill would slow the abandonment process by requiring the Interstate Commerce Commission to hold local hearings if requested. Finally, it would give the states freer rein to regulate intrastate railroad rates. Congress originally sought to rein in the states because their regulation reduced the revenues of the railroads by about $400 million annually. The industry could not afford the loss of these revenues before and we cannot afford them now.

CONCLUSION

Neither Burlington Northern nor the rest of the railroad industry are the picture of financial health. The Staggers Act has netted some financial improvements, but we still have a long way to go. The Interstate Commerce Commission is taking its job seriously and providing no excuses for amending the Staggers Act. We are laboring under a number of antiquated, costly federal statutes that make it nearly impossible for us to cut our costs and improve our efficiency. We are more competitive today because of the Staggers Act; however, to be truly competitive and viable long-term, we need to be treated like other U.S. industries. We ask both that you refrain from amending the Staggers Act and work with us to amend or repeal those statutes that single us out for unfair treatment.

ANSWERS TO QUESTIONS OF SENATOR ROCKEFELLER

1. You say you are not revenue adequate and that means you cannot afford to replace the whole plant that you have in place today. Who is suggesting that you must replace your entire plant today? In fact, aren't you doing just the opposite, by abandonments and sales to short lines?

> A. Attaining revenue adequacy has two key results. First, it insures the ability of the railroad to make continued capital investment. Secondly, it provides the incentive to make that investment in railroad properties. If a railroad's return on investment is insufficient to provide the ability or the incentive to make rail related investment, the railroad effectively "cannibalizes" its plant and other capital, and as these assets are consumed, rail service declines.
>
> Abandonments and short-line sales are means to eliminate unproductive portions of the railroad's asset base. Obviously, these portions will not be replaced and do not earn a return on investment in the revenue adequacy calculation. Under the ICC's definition, which I endorse, assets that are no longer "used and useful" are excluded from the investment base upon which a return is calculated to establish revenue adequacy. This adjustment does not detract from the need for a railroad to earn a return on an investment equal to its cost of capital to prevent consumption and non-replacement of its plant.

2. You testified that you lost $150 million on four recent coal decisions. Please give the dollar figure for each case and identify how much of your figure is interest, and the basis of the decision.

> A. The following table sets forth BN's losses on the four coal cases:

Case	Total	Reparations	Interest
San Antonio	$82,343,000	$55,343,000*	$27,000,000*
Omaha Public Power Dist.	22,900,000	17,500,000	5,400,000
Arkansas Power and Light	28,000,000	22,000,000	6,000,000
Iowa Public Service	16,027,000	**	**

*Negotiated settlement following partial ICC decision; the division of reparations and interest reflect BN's own internal allocation.

**Negotiated settlement prior to ICC decision; no allocation made between reparation and interest.

The San Antonio decision was based on the statutory rate cap of Section 203(c) of the Staggers Act. The other three Commission cases were based upon application of its Coal Rate Guidelines developed in Ex Parte No. 347 (Sub-No. 1).

3. How much money have you lost in each year because of the intrusion of competition into the Powder River Basis? You say that before this competition intruded you originated 145 million tons of coal. How many tons do you originate today? Do you disagree that it was in the public interest to allow competition in the Powder River Basin? If so, why?

A. In 1986, BN originated 114.8 million tons of coal in the Powder River Basin. It must be recalled that Chicago and North Western's (CNW) first operation on the joint line in the Powder River Basin was authorized by the ICC for environmental reasons, not for purely competitive reasons. However, CNW's presence has been a competitive force since its entry became imminent, even from those Powder River Basin points it does not serve. This is because BN rates from mines it serves exclusively must be kept competitive with CNW rates from mines on the joint line. If BN rates were not competitive with those rates from competing coal mines, the mines served by BN would be priced out of the highly competitive coal market.

4. You testified that your average coal rates have declined 7% since 1982. How much did individual rates, from the Powder River Basin, on average, decline when the haulage in question became subject to competition?

A. The following table shows BN's average rate per ton for coal since 1982.

Coal and Taconite Business Unit
Average Rate - Coal

Year	Avg. Rate Per Ton (Current)	Avg. Rate Per Ton (Constant)
1982	11.24	9.63
1983	12.21	10.09
1984	12.91	10.23
1985	12.17	9.34
1986	10.86	8.13
1987(Q1)	10.58	7.66

BN's originations from other than the Powder River Basin are only 5% of total tonnage and this table is representative of the Powder River Basin rates.

5. You testified that "competition" has driven those (the grain rates) down from Nebraska since the Staggers Act. May we presume that these rates you quote are competitive rates?

A. Yes. Nebraska grain rates are determined by the combined forces of intramodal competition, intermodal (motor-barge) and geographic competition. At this time, the barge industry has over capacity, resulting in reduced barge rates. BN or any other carrier's share of Nebraska grain transportation is the direct result of the carrier's competitive action, and absent competitive rates, it would have no share.

6. You state that you have no more rate cases at the ICC and "it is irrelevant because we have no more rate cases before the Commission because competition is controlling the rates we have at the present time." Since you have no captive shipper rates and all your rates have competition, why do you oppose the captive shipper and competitive access provisions of the Consumer Rail Equity Act?

A. The captive shipper concept applied in rate regulation and the competitive access criteria are not the same. A captive shipper in the rate context is one over whom the rail carrier has "market dominance", which means that there is a lack of any kind of effective competition. The C.U.R.E. proposal for competitive access is an over-reaction in that it would totally ignore the very real forces of intermodal, product and geographic competition. Access would be ordered under the C.U.R.E. proposal even where this competition effectively restrained rail rates. This is economically unjustified.

BN has been supportive of AAR and shipper efforts to negotiate changes in competitive access rules so that they operate in an economically rational way. That we have been able to resolve our rate cases and our competitive access problems through cooperative efforts demonstrates the sufficiency of present law and lack of need for new legislation.

7. You said your "high water mark" for the BN was 1984 when you earned $528 million. Isn't that the last year you had an effective monopoly in the Powder River Basin? Isn't your problem "competition", not the C.U.R.E. bill?

A. The year 1984 was a high point in BN's earnings for a variety of reasons and it is only somewhat coincidental that the year also marked the entry of the CNW in the Powder River Basin. All traffic levels were strong that year, and overall the country's economy was strong. Western grain movements were especially strong because of the severe drought in the eastern states. Because we are a derived demand industry, the strength of the country's economy directly impacts our traffic levels. In addition, we were beginning to see the benefits of the cost cutting measures that we had been taking in the immediately preceding years. Our earnings in 1984 cannot be attributed to "an effective monopoly" in the Powder River Basin.

As I have previously pointed out, competitive forces have been and are at work today, and neither the C.U.R.E legislation nor other measures purportedly enhancing competition are warranted.

The anomaly of the C.U.R.E. proposal is that it simultaneously urges freer entry and increased rate regulation. The historic argument for entry and price regulation of the rail industry has been that railroads, like public utilities, are "natural monopolies" -- i.e., they have significant sunk costs. Since these sunk costs are thought to be a natural barrier to entry, the prices of "natural monopolies" have traditionally been regulated to preclude monopoly profits.

Now, however, there are not such barriers to entry preserving the railroad as a natural monopoly. Not only has the entry of other modes been permitted, but to a large extent it has been federally financed. New railroad entry is economically practical (witness the Powder River Basis project), and the ICC has proposed exempting from regulation all new rail construction. C.U.R.E. proposes additional free entry. All of this is fundamentally inconsistent with the notion that railroads are natural monopolies requiring rate regulation. Freer entry ought to be accompanied by less rate regulation, not more.

Lastly, the very concept of mandatory sharing of plant runs counter to a basic free enterprise concept: an investor ought to reap the benefits of his investment. This tenet of our basic economic and political philosophy ought not be subverted without compelling reason.

8. You gave a number of specific grain haulage rates from Lincoln, Nebraska, to various destination points for the pre-Staggers period and for today. Please give us the revenue to variable cost ratio for each of your cited rates for the pre-Staggers period and today. (i.e. corn from Lincoln to the Gulf - $1.75/$.86; corn to the Pacific Northwest - $1.225/$.85; and wheat to the Gulf - $1.66/$1.02.)

A. These ratios will be provided.

9. For grain, you compared single car rates in the pre-Staggers era to unit train rates today. What are your single car rates for this same grain movement today? What were your unit train rates for these same grain movements in the pre-Staggers Act period?

A. The following table sets forth a comparison of single car rates in the pre-Staggers era and today. Where 54 car rates are not shown pre-Staggers, they did not exist so no direct comparison is possible. Since inception of our grain train program in 1980, we have had 50%-65% of our grain business in unit trains.

NEBRASKA RATES

Rate

Corn to Gulf (Lincoln, NE)

Pre-Staggers: Single Car Rate 175¢
Today: Single Car Rate 145¢ (17% lower)
54 Car Rate 86¢ (50% lower)

Corn to PNW (Lincoln, NE)

Pre-Staggers: 54 Car Rate 122½¢
Today: 54 Car Rate 85¢ (31% lower)

Wheat to Houston, TX (Lincoln, NE)

Pre-Staggers: Single Car Rate 196¢ (RCCR X003 Level)
Today: Single Car Rate 157¢ (5% lower)
54 Car Rate 102¢ (39% lower)

Wheat to PNW (Grand Island, NE)

Pre-Staggers: Single Car Rate 213¢ (RCCR X082 Level)
Today: Single Car Rate 219¢
54 Car Rate 166¢ (14% lower)

The development of unit train rates was one of our competitive efforts which had the dual effect of offering the grain shipper better transportation at a lower rate and enhancing our efficiency, allowing us greater pricing latitude to meet our competition and attain rail share in the face of over-capacity in the grain transportation system. In effect, the introduction of unit train rates for grain was a "win-win" for the grain shippers and BN.

10. You testified that one of your trucking companies now moves "ten percent of the soda ash that was formerly judged to be captive" on the UP. Could trucks move all of the soda ash? If so, how many truckloads annually would it take to move the soda ash in question and what is the length of truck haul involved?

A. It is probably not practical to move all UP soda ash by truck. That does not mean, however, our trucking is not a strong competitive influence. A competing mode need not be able to handle all of the traffic to exert a downward force on the rates for the remainder of the traffic.

11. You said that the ICC has recently made some captive shipper decisions against the BN, "much to the detriment" of my shippers. Your shippers were the ones who brought complaints against you and won relief at the ICC. Would you explain how these decisions were "much to the detriment" of your shippers?

A. The transcript should read (at p. 89), "But the Commission is there and they have made some decisions, much to the detriment of my shareholders in recent days, to address those captive issues". The reference at line 19 to "shippers" is a transcription error.

12. You made an interesting comment to the effect that BN introduced truck competition to help the grain farmers in Montana and you still got hit with a harsh judgment in the McCarty Farms case. Do BN controlled trucking firms provide the competition to the BN railroad for these grain shipments from Montana?

A. BN introduced unit train rates (and reduced single car rates) in Montana in late 1980 to meet existing truck competition. At that time, independent grain truckers and general commodity truckers carrying back hauls to the PNW handled roughly 50% of the westbound Montana grain. BN did not truck grain and the truckers were not affiliated with this company. Our reduced rates and increased efficiencies through the unit train program which became widely accepted because dual benefits to the shippers and the railroad I have previously mentioned resulted in BN gaining a larger market share. This pro-competitive effort resulted in the ICC finding BN "market dominant" in the McCarty Farms case, even though our effort and resulting increased market share was a direct reaction to competitive forces which remain effective to recapture this grain traffic if BN were to make improvident rate decisions.

13. When you quote a discount rate with a shipper, do you provide the shipper with your estimate of the revenue to variable cost ratio of the rate? Would you provide that information to a shipper who asked for it?

A. Estimates of revenue to variable cost ratios today are readily available to virtually all shippers. We don't routinely disclose revenue to variable cost ratios only because they usually are not a point of contention in the negotiation process. The shipper is interested in obtaining the most cost effective transportation for his product. This involves his analysis of the effectiveness of his various transportation options rather than the profitability of those carriers offering the options.

Senator ROCKEFELLER. Thank you very much.

Mr. Snow.

Mr. SNOW. Mr. Chairman, I too have a lengthy statement. I would ask that it be accepted for the record, and I will briefly summarize it.

Last week Mr. Dempsey, the President of the Association of American Railroads, who is to my right, appeared before the committee and gave a lengthy and I thought very thorough and thoughtful statement about the economic condition of the railroad industry. Today you have heard from three railroad executives.

Let me say that our situation at CSX—and CSX is the successor company to the Chessie and the Seaboard mirrors the situation that Mr. Dempsey described in the railroad industry as a whole, and which the gentlemen to my left just described in terms of their own companies.

The industry after the Staggers Act is certainly more competitive, more market responsive, and more productive than at any time in modern railroad history. By these measures, the Staggers Act has to be judged a great success.

But the earnings in the railroad industry are still anemic. The industry still suffers from a fragile financial structure, and the outlook, I must say, is quite daunting, even precarious.

The basic problem we face is an enormously hostile external environment, an environment characterized by decline in traditional industries that railroads served. Enormous changes are sweeeping through the American economy and railroads are not immune to those changes.

Smokestack America, agricultural America simply is not what it once was, as you all know so well. We are in the period of a global economy. Many of our customers are buying abroad, and we simply do not have the demand, the aggregate demand for railroad services that once existed.

As a consequence, the industry today faces enormous excess capacity. We simply have more lines, more locomotives, more freight cars, and more people than can be justified for the long term.

In addition to the aggregate demand problems facing the industries which are our shippers, we also face intense competition among ourselves and from the trucking industry, that every year, year in and year out, becomes more and more productive, more and more efficient, and more and more competitive with us.

Over the period 1980 to 1986, the post-Staggers Act period, the history of the railroads can be characterized as a race. It is a race between falling revenues and falling costs. And we, the railroad industry, are not winning that race.

In fact, we are falling further behind. Over that period, revenues at CSX on an inflation-adjusted basis are down 24.4 percent. Expenses are down, too. They are down a whopping, really unprecedented 24.3 percent. Never before in the history of this industry have we seen such efficiency improvements, such productivity gains.

But in real terms, our earnings are down 27 percent. We hear a lot of talk about railroads awash in riches. Those figures, I suggest, Mr. Chairman and members of this committee, suggest something quite different, something much closer to reality—an industry that is struggling, an industry with anemic earnings, an industry that really is deeply troubled.

I must say, without the Staggers Act these numbers would have been a lot worse. In fact, I think we would have faced a disaster. The fact of the matter is, and it is very regrettable, we the American railroads are disinvesting from the railroad industry today because our earnings simply are not adequate.

We regret the necessity to do it, but do it we must as long as our earnings stand as they do today and look as they do today. To put it in very simple terms, the industry does not have adequate earnings. Our earnings outlook is not good, and therefore the industry will shrink.

In real terms, my company, CSX, is 25 percent smaller than it was in 1980 when the Staggers Act was enacted. Then we had 75,000 employees. Today in the railroad we only have 42,000 employees, and we recognize that that number will come steadily down in the years ahead.

Mr. Chairman, to respond to this harsh external environment, we are shrinking and we are declining. We are trying to take the costs out, and the only hope to preserve a private sector rail industry in this country is through the market freedoms to shrink our cost base, to reduce costs, to respond to the market, and to become more productive and more efficient.

It is for those reasons that I would urge you to reject the efforts that are being made to reregulate the railroad industry, and in fact I would urge you to think in terms of giving us more market freedoms and addressing the railroad retirement issues and the FELA issues and the other issues which, frankly, bedevil the industry today.

I thank you for the chance to be before you.

[The statement follows:]

STATEMENT OF JOHN SNOW, PRESIDENT AND CEO, CSX TRANSPORTATION

Mr. Chairman, the scheduling of these hearings is timely in light of the recent successful public offering of the Federal govenment's interests in Conrail. The success of that offering underscores the judgment of the marketplace regarding the economic viability of Conrail. In many respects, the Conrail saga symbolizes the troubled past and the challenges and opportunities of the future for America's railroads. During the extensive Congressional deliberations that preceded the public offering, Conrail's status as a viable economic entity became clear. It was equally clear that the enactment of the Staggers Act was one of the principal reasons Conrail was able to sustain its recovery and subsequently to become successful. In a recent report on the viability of Conrail, the Congressional Budget Office observed: "Conrail has made extensive use of the Staggers act to price and market aggressively its transportation services. An important part of the improvement in Conrail's financial condition since 1980 stems directly from the Staggers Act and its reduction of the federal economic regulation of railroads." (CBO, "Economic Viability of Conrail." August, 1986, pp. 7–8.)

We all remember the creation of Conrail from the wreckage of the Penn Central and six other bankrupt railroads in the northeastern United States. We should also recall that the rigidities of the system of economic regulation of America's railroads raised the the specter of financial instability and bankruptcy for several of the nation's railroads prior to the enactment of the Staggers Rail Act in 1980. Although the Staggers Act does not guarantee rail carriers an economic return on investment, it does provide a framework within which they can operate more like independent business enterprises. Clearly, if the rail transportation industry is to be successful in its struggle to overcome the burdensome residues of the past, to meet the challenges of the present, and work for the future, the freedoms granted under the Staggers Act must not be diminished.

I. RAILROADS IN THE POST-STAGGERS ERA

The environment in which railroads operate today is highly competitive. Inter- and intramodal competition is heightenend by the fact that the absolute size of the freight transportation market has not been growing in recent years. Between 1980 and 1985, intercity freight ton-miles decreased 1.2% from about 2.49 billion to about 2.46 billion, despite a 14% increase in industrial production over the same period, and a 12% increase in real GNP. This reflects the structural changes that are taking place in the American economy and are reducing the movement of bulk traffic.

Other modes of transportation, particularly trucks, have been successful in eroding the market position of railroads in intercity freight transportation. For example, in 1946 the share of freight ton-miles for railroads was about 68%, while trucks accounted for only 8.7%. By 1986, the railroad share of intercity freight ton-miles was 35.9%, while the share for trucks had risen to 25.5%.

The effects of the intense competition that characterizes the recent era are reflected in the 4.5% decline in revenue ton-miless for Class I railroads between 1980 and 1985. Moreover, there was a 14% decline in revenue carloadings, in the face of an 11.3% decline in tonnage over the same period. Equally disturbing, intense competition has contributed to a dramatic decline in the revenue yield for Class I railroads. Real gross revenue yield in constant dollars for Class I railroads fell about 21%, from 3.57 cents per ton-mile in 1980 to 2.81 cents in 1985. During this period, revenue yield declined at a rate of about 3.9% per year, while inflation, as measured by the GNP implicit price deflator, increased at a rate of about 4.5% per year. A continuation of such divergent trends over the long-term do not augur well for the future of the railroad industry.

Although these indicators are cause for serious concern, it is still too early to determine, with any confidence, how successful the nation's railroads will be in acting upon the opportunities offered by the Staggers Act to earn an economic return on capital. We are making the transition from a long period of economic regulation that prevented railroads from competing into an era where we at least have the tools needed to sustain ourselves in a competitive market. Clearly, the railroad industry faces significant challenges and an uncertain future. Nevertheless, the industry is responding aggressively to the pressures of today's marketplace. We are reducing costs, making progress in increasing productivity, and offering new and improved services to our customers. We are, in short, taking the issue of competitiveness very seriously.

II. CSX RAIL TRANSPORTATION

CSX Transportation has not been immune to the intense competition in today's transportation markets. For example, from 1984 to 1986, our freight carloadings declined 6.2 percent. But our revenues declined 14.4% in real terms, an indication of declining revenue yields. In this regard, it is worth mentioning that our carloadings of coal declined 6.25 during this period, while revenues from our coal traffic declined 16.4%. This reflects the simple fact that the coal industry and the railroads are in the same competitive market, and if a coal company served by CSX loses sales, we lose. Indeed, in today's highly competitive market for coal, exacerbated by substantial domestic coal productive overcapacity (estimated by some to be on the order of 100 million tons), there are significant economic pressures constraining rail rates for coal. Current market conditions have worked to the advantage of electric utilities. CSXT has been forced to reduce its rates to keep the mines it serves in the market, while the utilities are able either to buy coal or to buy power from other suppliers.

CSX Transportation has been moving aggressively to take advantage of the freedoms offered by the Staggers Act to respond to the challenges of the marketplace. The company's innovative organization into three independent, yet inter-related, business groups is designed to facilitate high-quality service in today's transportation market.

We have recognized that we must significantly reduce labor and other costs, and we must improve productivity if we are to compete effectively in the marketplace. Our efforts in this regard have meant that we have had to make some difficult decisions, but we have not shied away from making them. For example, between 1980 and 1985, CSX railroads reduced employment 27.4%. This contributed to an improvement in productivity as revenues per employee increased 17%. But we recognize that there is more to do.

We have moved aggressively in the area of plant rationalization by reducing the amount of excess plant and equipment. For example, since 1982, we have reduced our locomotive fleet by about 42% and our freight car fleet by 40%. We have reduced our route miles by about 9%, which we have accomplished in part through short line sales. In this regard, CSX Transportation short line sales are the basis for the recent inauguration of the KWT Railway and the R.J. Corman Railroad Corporation, two new short line railroads providing rail service over former CSX lines in Tennessee and Kentucky.

We expect the end result of our efforts at CSX Transportation to be a railroad in fighting trim to meet the competition. For example, we have adopted a strategy based on the efficient operation of a core railway network. To this end, we expect our trackage to go from approximately 23,000 route miles to 15,000 route miles.

Finally, we have been looking to the future. We are positioning ourselves to become the nation's premier freight transportation company. CSX Transportation has taken a leadershp role in making the concept of "one-stop shipping" a reality by working to integrate ocean shipping, rail transportation, trucks, and barges. Our vision of the future is guided by a recognition of the growing interdependence of the world economy. Our response is to become a "full service" transportation company to meet the nation's transportation needs for the remainder of the decade and beyond.

III. THE STAGGERS ACT AND THE FUTURE OF THE AMERICAN RAILROAD INDUSTRY: GETTING FROM HERE TO THERE

Mr. Chairman, there should be no illusions about the difficulty and the enormity of the challenges facing CSX Transportation and the railroad industry in today's marketplace. Nevertheless, we are cautiously optimistic about the future. We are "cautiously" optimistic because all of our efforts will be for naught if the proponents of the re-regulation of rail carriers are successful in their assault on the Staggers Act. The Staggers Act represents a bridge to the future for the nation's railroads. It is, as the song goes, "like a bridge over troubled waters."

As the portrait painted today of the current economic circumstances of the rail industry illustrate, the waters are troubled indeed. The economic condition of the nation's rail carriers is fragile. Were it not for the flexibility provided by the Staggers Act which allowed the rail industry to respond to adverse economic circumstances, we would be waist deep on those troubled waters and sinking fast. The industry is working to realize its economic potential; but this can only be accomplished if the current policy atmosphere is not changed by those seeking to turn the regulatory clock back to another era under the guise of "fine tuning" the Staggers Act. (That's like saying that Delilah was only "styling" Samson's hair!)

This claim is disingenuous at best, for the proponents of rail re-regulation would fundamentally alter the existing regulatory regime established under Staggers by severly restricting—or, in effect, repealing—the economic principles that are at the foundation of the Act. This project is bing proposed allegedly to address the problems of captive shippers that have not been addressed by Staggers. However, it is important to note that, under the auspices of the ICC, rail carriers and major shipper groups have been provided the opportunity to explore approaches to the resolution of differences arising under the Staggers Act. As a result, compromise agreements have been successfully negotiated between the rail carriers, the National Industrial Transportation League, the American Paper Institute, and the General Manufacturers of America with respect to market dominance and competitive access issues. These agreements have been adopted by the ICC.

It is, as the saying goes, difficut to argue against success, and the re-regulators are no exception. Indeed, they appear to have included the major features of these agreements in their legislative proposals. Unfortunately, they have also supplemented these agreements with additional language that is at odds with the intent of the comprise agreements, and would effectively negate the foundations of the Staggers Act. Let me briefly comment on a few of the issues raised by these proposals.

A. RE-REGULATION ISSUES

The appropriate level of investment in the nation's rail system will be determined by the market; that is, adequate investment will flow to a rail carrier only if the revenues earned are sufficient to cover the current cost of capital. Thus, service will be provided to shippers only if providing that service earns revenues that cover the cost of capital necessary to provide the service required.

The fundamental economic principle underlying the Staggers Act is the proposition that users of the nation's rail network should pay for that use in accordance with their demand for service as determined by the competitive marketplace. The resulting system of differential pricing takes into account the varying levels of demand for service among shippers. The so-called "captive shipper" benefits from this system because it permits the railroad to serve shippers with the high elasticity of demand, reducing the fixed cost burden that would otherwise have to be borne by the shipper whose elasticity of demand is lower.

In this system, a rail carrier must set its rates at a level that is not so high as to divert traffic to competitors, or so low as to make no return to its fixed costs. The reason for this approach is clear: If a firm is denied the opportunity to earn adequate revenues, it would not be able to raise investment capital to operate and maintain its current assets. Similarly, the firm would not be able to raise new capital to provide new or expanded services.

Unfortunately, proponents of re-regulation are proposing to ignore the policy established in Staggers that requires the ICC to recognize that "rail carriers shall earn adequate revenues." In place of this policy they would impose severe restrictions on differential pricing in several ways. The major problem with the C.U.R.E. is the access provisions. These provisions would force a rail carrier to turn over its facilities to its competitors at a price imposed by the regulator under a formula which takes to account of the owning line's loss of revenues. No other American industry labors under such a requirement. In particular, utilities, which enjoy a monopoly in their service area far greater than anything the railroads may have had in the past, have never been required to accept such a Draconian measure. The C.U.R.E. bill would also grant to the states increased regulatory power in areas where, under the Staggers Act concepts, market forces served as an adequate constraint. In essence, C.U.R.E. would add the power of 48 state regulatory agencies to market forces as a constraint on railroad pricing. In like vein is the attempt by the re-regulators to banish the concept of revenue adequacy from rail transportation policy. The only acceptable test of whether a railroad, or any other business, is revenue-adequate is whether it is earning its current cost of capital. No business firm in the United States, no utility, would measure its present and future viability by any other standard. However, the re-regulators would do so in the case of the railroads. They have sought to obfuscate by equating revenue adequacy with net income, thus implying that profitability is the test of revenue adequacy, which is clearly not the case. Yet proponents of re-regulation point to investments by rail carriers in other business enterprises as evidence that rail carriers are earning excessive profits. I would only note that this is clearly irrelevant to the issue of revenue adequacy, since diversification can also be undertaken by firms with low and normal profits as well. I might point out that our earnings as an industry are subnormal by any standard. In the light of this fact, diversification to other lines of business is not surprising.

The proponents of C.U.R.E. legislation asked the Congress to accept that these provisions are necessary in order to enhance railroad competition. In fact, they do the opposite. Rail competition is enhanced only when the railroads are healthy, not when they are borderline bankrupts. Thus, competition is enhanced only where the railroads can earn the investment necessary to improve their plant and service to meet the standards demanded by the shipping public. The C.R.R.E. bill is not a "cure" at all. It will drastically weaken an industry which is only beginning to recover from a long siege of regulation which handcuffed its ability to compete and thus led to its near bankruptcy.

B. LABOR PROTECTION AND SHORT LINE RAILROADS

The recent expansion of short line railroads is one of the most important developments in recent railroad history. The expansion of short line, or regional, rail carriers provides an opportunity for rail carriers to rationalize their systems, and, simultaneously, preserve service for shippers on light density lines, most of which might be abandoned. Clearly, both outcomes are in the public interest.

Substantial economic barriers to short line sales were removed in the Gulf and Mississippi case in which the ICC ruled that labor protection is not mandated when a rail carrier sells a light density line to a new independent railroad. This provided substantial incentive for carriers to seek short line sales rather than abandonment. However, the growth of regional railroads has been a cause for concern among rail labor, who suspect that short line sales are simply a backdoor method of union busting. Not surprisingly, rail labor supports the enactment of legislation to extend protection to short line sales.

Let me emphasize that the decision to sell a line to a short line railroad is not directed at employees. It is strictly an economic decision directed at assets which are not, for a number of reasons, realizing satisfactory returns.

The adoption of some of the more extreme labor protection proposals, such as six years protection, would undermine the economic viability of such ventures to the detriment of shippers, and, ultimately, to labor as well. To the extent that purchases of light density lines by a short line operator are no longer viable investment opportunities because of labor protection obligations, a rail carrier would be faced with abandoning that service altogether.

There are no guarantees that all short line railroads are going to be successful. Success will be premised on the confluence of many favorable circumstances, one of which is the continued successful operation of Class I railroads. However, if the proponents of rail re-regulation succeed in their efforts to overturn the Staggers Act, the negative effects will be felt by all rail carriers, Class I railroads as well as short lines.

Mr. Chairman, the rail industry is facing difficult economic times. The intercity freight transportation market is not growing; and their is intense competition eroding our traffic base and revenues. However, without the Staggers Act rail carriers would not have the flexibility to respond effectively to adverse economic conditions. Indeed, as the Congressional Research Service observed in a 1985 report, "the Staggers Act probably helped railroads during the recessions in the United States since 1980." If the rail industry is to continue to respond to the rapidly changing economic circumstances of the 1980's and beyond, the efforts of the re-regulators to overturn the Staggers Act must be repudiated. If they are successful, the future for the rail industry is bleak indeed.

[The following information was subsequently received for the record:]

RESPONSES TO QUESTIONS FROM SENATOR ROCKEFELLER TO JOHN SNOW.

1. QUESTION: You testified that Congress should reject "reregulation" but give you "more market freedoms." What additional market freedoms do you seek? Do you propose removing all captive shipper rate protection?

ANSWER: The freedoms to which I referred are not those related to the so-called captive shipper provisions of the Staggers Act. Rather they go to the basic issue of how railroads should be treated within a market-driven economy.

It has long been my position that the railroads should be under the same rules and procedures as any other business. To the extent that it can be proven that they exercise monopoly power, they should be covered by the several antitrust statutes which have served the country so well in this century.

We have repeatedly tried to make the case that we have no intention of pricing ourselves out of business. We do not carry nuclear power, we carry almost no oil for electric generation purposes - we lost that market long ago to the efficiencies of the pipelines.

The coal companies are not our primary customers in the transportation of coal. Rather we must serve the utilities which burn that coal and with whom we make our contracts. In almost all instances that utility has access to coal other than that which we carry on our system. In may cases that coal can be brought by a collier or by another railroad or by barge, or in rare instances by truck or a combination of any or all of the above. It can also be brought from another country or from a different region of this country. Because of these competitive forces, we try to price our services to ensure our continued survival.

It is also our judgment that we should be able to dispose of surplus plant more swiftly in order to better husband the remaining resources we have. We are aware of the furor that surrounds the abandonment, sale or transfer of assets in any industry, but we are the only industry that must go through special procedures to take similar actions. In short, we are not a deregulated industry. The best that can be said is we are partially deregulated and we face a continuing battle to retain what market freedom we now enjoy.

2. QUESTION: When you quote a discount rate with a shipper, do you provide the shipper with your estimate of the revenue to variable cost ratio of the rate? Would you provide that information to a shipper who asked for it?

ANSWER: It is not our policy to provide such information to shippers in discussing rates. Nor do I know of anyone else in our industry that does. Rates for service are subject of intense negotiations between the railroad and our shippers. There is ample evidence of the intensity of such negotiations, particularly in the area of coal. For example, between 1984 and 1986, our coal revenues declined 16.4% in real terms. (Carloadings for coal declined 6.2% during the same period.)

In addition, it would certainly not be good business practice to provide an advantage to the other parties in such negotiations by providing that type of information. If asked for such information by a shipper, therefore, we would respectfully decline to make it available.

Finally, we believe that there is in place a reasonable mechanism to be utilized by a shipper who believes that rates are unjustifiable. In recent decisions of the ICC, shippers who had what they considered to be a body of evidence about the unreasonableness of rates were successful in obtaining substantial adjustments. Most of these were electric utility companies who brought their cases under variable cost ratio principles and they were successful.

Above all, we believe that the contract provisions of the Staggers Act provides the appropriate method by which shippers can ensure both stability and reasonableness of the costs they pay for transportation services.

Senator **Rockefeller**. Thank you, Mr. Snow. Two Senators have come in since the second panel began.

Senator Danforth, do you have any statement you would like to make?

Senator **Danforth**. I have no statement.

Senator **Rockefeller**. Senator McCain?

Senator **McCain**. No, thank you, Mr. Chairman.

Senator **Rockefeller**. Let me just ask all of you, do you agree with the ICC's approach in the McCarty Farms case? And that is—and you know, we can argue about the word "cap," but the ratio, variable cost ratio, was up to between 214 and 224 percent based on average rate of moving that commodity. It is a cap by any other name, however you choose to interpret it.

Do you gentlemen agree with the idea of a cap based upon the average cost of moving a commodity, as put forward in the McCarty case?

Mr. **Lewis**. I would defer to Mr. Gaskins.

Senator **Rockefeller**. I would definitely come to him, but I am interested in all of your answers.

Mr. **McKinnon**. Senator, I do not believe in arbitrary caps. However, I am not familiar with the opinion in the McCarty case and I could not comment on the debate between you and the chairman of the Commission as to its meaning.

Mr. **Gaskins**. Senator, I recognize it is desirable for the Commission to come up with an expedited way of making judgments with respect to maximum rates when there are small shippers involved. But unfortunately, from my quick reading of the case, I think that they have an illogical solution in this particular instance. Having decided that Burlington Northern is market dominant in this territory, they have said that the maximum permissible rate is a rate which is an average of all similar such rates in the country. This says that half of all the rates are illegal and have to be reduced.

Well, if you had subsequent cases, pretty soon you would drive all the rates to, I presume, zero, because if almost half of them are always illegal then you would have to give the money back. And if you do it again and again and again, you know, there would not be a lot of money left. So I would hope that the Commission would come up with a little better method before they are done. I must say that I have not studied the decision in great length. But based upon my limited study, I would not recommend it to anyone else.

Senator **Rockefeller**. I take it that it is possible that you may be appealing that case?

Mr. **Gaskins**. Yes, sir.

Senator **Rockefeller**. I might ask each of you, do you think that the ICC's revenue adequacy test is a fair measure of the financial health of your railroads?

Mr. **Lewis**. Are you going to go leftward?

Senator **Rockefeller**. Either way. You start, Mr. Lewis.

Mr. **Lewis**. We think it is. And actually I think, Senator, what you have to look at in this business is basically what your revenues can be, what you are going to move, and whether you are going to end up with more money than you spend.

And if you take the entire picture and look at it in relation to Staggers and look at it in relation to CURE and look at it in relation to FELA and railroad retirement, the bottom line is we are in a lousy business.

And we are not crying to poor-mouth. We are trying to survive, because we hope to get by CURE and then come down here and try to get you convinced that we should do something about railroad retirement, FELA, antitrust, and some of the other issues that we would like to have in terms of being able to compete in the free enterprise system.

So the bottom line is Union Pacific feels that we are making an adequate return in the sense we are surviving, but in the sense of return on capital, as Heather Gradison indicated, we would be better putting it in a savings bank.

Senator ROCKEFELLER. If I could just follow on that, Mr. Lewis, the Standard & Poor's analysis of Union Pacific Corporation gave you recently, that is this year, gave you a preliminary rating of A plus, outstanding ratings affirmed, indicated very strong operating performance of the railroad, reflecting substantial cost reductions, productivity improvements, things that you have mentioned.

Over the longer term, these events strategically broaden Union Pacific's market position and position it for greater profitability going forward. It is a very glowing document.

Mr. LEWIS. If I could comment on that. You have to realize, that is somewhat different than the Norfolk Southern. We are not just a railroad, not that there is anything the matter with just being a railroad. But we also have 450 million barrels of oil that are worth $4.5 billion, which was acquired a while ago.

And we are involved in the trucking industry, and we are involved in some other businesses.

Senator ROCKEFELLER. So are these gentlemen.

Mr. LEWIS. If you look at it from a railroad performance standard, if I had a way, which I did in 1980, to sell the Reading Railroad to Conrail, if I had a way to sell our railroad to the Federal Government for anywhere near our investment, we would do it.

And again, if you look at the Conrail situation that you raised with Mrs. Gradison, you look at the facts of that, and we have put $7 or $8 billion in that. I appeared before this committee and you supported us. We put $7 or $8 billion in that, and you sold it for a quarter of what we invested in it.

That is a pretty clear indication that it is not a good business.

Senator ROCKEFELLER. None of you gentlemen would be in favor of taking out of the Staggers Act the revenue adequacy test, am I right?

Mr. LEWIS. Correct as far as I am concerned.

Senator ROCKEFELLER. Is that true of all of you?

Mr. MCKINNON. Personally, I am in favor of keeping Staggers as it is now, because I think if we do not we are going to create another round of the case backlog and all that sort of thing.

Senator ROCKEFELLER. You would not be in favor of removing the revenue adequacy test. Could each of you tell me how much captive traffic you judge yourselves to have?

Mr. LEWIS. We do not have any, obviously.

Mr. SNOW. Senator, in the sense of somebody having no alternatives whatsoever, in that sense of captive I daresay there is nobody that is captive to the CSX railroad. There are, though, shippers that have fewer alternatives than others.

Most shippers can get access to another railroad. They can truck out. They can get to water. They can use some means of transportation, or they can use product or geographic competition.

So in the sense of having no options, no alternatives, I think there are scarcely any. There are instances where railroads have what the Commission calls some degree of market power, not indistinguishable, I would suggest, from the sort of market power that exists throughout the breadth of the American economy, and which gets dealt with very nicely through the antitrust laws.

Yet we continue with a regulatory system based on basically public utility sorts of concepts for an industry that is fundamentally competitive. So I would say there are few truly captive shippers.

Senator ROCKEFELLER. Mr. Gaskins.

Mr. GASKINS. Well, if you use the Commission's standards, obviously we have some grain customers in Montana that are captive. And we had some coal customers, but Mr. Lewis and his colleagues took care of that, again using the Commission's standards.

I would say that on our system we have a fair number, maybe ten percent of our shippers, that from their perspective do not have very many rail alternatives. But unfortunately, they have all got good highway alternatives, and the world is moving against us in that regard in the sense that an awful lot of our traffic moves by truck and that includes grain.

Senator ROCKEFELLER. So your answer is what? Little or none?

Mr. GASKINS. Well, we have a lot of grain shippers. But I would say less than ten percent could be classified as captive by any standard.

Senator ROCKEFELLER. And before the entry of the Chicago and North Western into the Powder River Basin, how much did you have?

Mr. GASKINS. If you use the ICC standards, which I disagree with, but if you use their standards, it was a very large part of our business. That was about 30 to 40 percent.

Senator ROCKEFELLER. 30, 40 percent.

Mr. McKinnon.

Mr. MCKINNON. I cannot give you a number of the shippers on our railroad who have no other rail access. I share the view that was expressed by one of the other gentlemen here, that virtually all of those shippers are not captive. But that is a definitional matter.

I would say the order—and this is a guess off the top of my head—the number that have no other rail access might be ten percent. I am not sure. But their markets have other access and, as I said earlier, we and they are captive to those markets.

And we are most concerned about those who do not have another way to get to the market other than ourselves, because we are dependent upon them to keep our own markets. But I cannot give you a better number than that, Senator.

Senator ROCKEFELLER. Thank you, sir.

Mr. Lewis.

Mr. LEWIS. In terms of alternatives, basically the only business we have that could be considered captive is soda ash. We move about 500,000 tons out of Wyoming. On the other hand, there is a trucking firm there that moved 200,000 tons.

So I guess really, other than the fact we enjoy sharing business with Mr. Gaskins in the Powder River Basin, we do not have any legitimate totally captive shippers on the Union Pacific that I know of.

Senator ROCKEFELLER. Thank you, gentlemen.

In order of appearance, Senator Pressler.

Senator PRESSLER. Thank you.

You are all chief executive officers who make quick, crisp decisions every day. Would each of you give a two or three step process that you would recommend be public policy or a combination of action by the railroads and government to resolve the railroad retirement system issue?

Now, we have heard it said that this is part of the financial problem. On the other hand, we want to be fair to people. If we could do two or three things, a combination of what Congress might do plus the industry, what would you like to see done with that in the next year or two, if you could just make a decision and do it?

Mr. LEWIS. Senator, if we are starting left to right, to kick it off, I think we should review that. If you add up the total cost of railroad retirement, the total value of the railroads in terms of their market value, the cost of retirement exceeds the railroads' net worth.

What we have to do is to work with our union counterparts, ourselves, and perhaps a study by the GAO. I do not know who the group is. We would like to have a study that is not somebody, but somebody who really looks at this. We should get out from under that.

This is in worse shape than social security. It is a serious problem. It was when I was Secretary of Transportation. I do not have an answer. But it is clear the railroads are never going to be able to cover this and we are going to be in deep trouble from 1995 to the year 2000.

Senator PRESSLER. How would you get out from under it? Who would take it over?

Mr. LEWIS. I think what we have to do is figure out how we merge it with social security. And I also think that the railroads have to absorb some of the costs. The problem you have, you know, you look at the Rock Island and the Conrail. And I was part of the Conrail bankruptcy when I was a trustee of the Reading Railroad.

We have to figure out how we cover those people, and you are going to end up with one person working ultimately, as we get down to where we are going to have to be in the railroad industry to compete with trucks, we are going to have one person working supporting four people in retirement. It is now, I think, one to three.

So we have got to figure out. I guess what I am saying is I do not know the answer, but I do know that it is a problem we have to face, and somehow we have to share some of the burden.

I have to pay some of the costs, the Union Pacific, for Conrail, the Rock Island, and so do my colleagues to my right. On the other hand, if I could walk away with my problems and just take care of the Union Pacific and let all the problems of the past go, I would be delighted to just take my own problems and go.

But I cannot, because we are all in a pool, and the pool we cannot afford because the employment has gone down so much. And it is going to go down more.

Mr. McKINNON. I would concur with what Mr. Lewis says. I would also say that the kind of crisp executive decision making that you are discussing, the board of the Association of American Railroads has designated—asked each railroad to designate two top people to join with others in making the study.

So we are crisp decision makers like others in the world, but the problems are just exactly what Mr. Lewis said, and we ultimately have to face them in some fashion of the sort that he mentioned.

Mr. GASKINS. I would just make two comments. One is, from the Burlington Northern's perspective, we think the system is a little unfair as it stands. We have about 7.8 percent of the retirees in the country that we are responsible for and we are paying 10.3 percent of the current compensation. Furthermore, that discrepancy, paying more than what we consider to be our fair share, is going up. I would suggest that a little compromise on all sides would have to be part of any solution to this problem.

Second, one thing that really merits study would be to authorize the railroads to buy out surplus people, that is, people, we do not need to employ today. If we can buy out surplus people we not only keep them out of this railroad retirement problem ultimately, but we can get ourselves in better financial condition to be able to pay those pensions we really do have an obligation to pay to our retirees.

Mr. SNOW. Senator Pressler, I would just add that the problem is an overwhelming one. It is the railroad industry's version of the Federal deficit perhaps, or world peace. We do not have an answer for it right now. There does not seem to be a simple answer.

One thing is clear. The railroad industry on its own cannot fund it. The cost of funding it under ERISA standards would be $1.6 billion a year, which dwarfs railroads' net income per year.

It has to be some combination of actions with respect to benefits, with respect to employer taxes, perhaps with respect to Federal responsibility, state responsibility. I do not know the answer, but it clearly is an overwhelming problem that has to get addressed.

It is a dark cloud over the future of the railroad industry.

Senator PRESSLER. I will address this to Drew Lewis and then to anyone else on the panel who wishes to respond. The CURE proponents have argued that the effect of their legislation will be to reduce the profits of the railroads. Let me ask a two part question regarding that statement.

First, do you believe that you are sufficiently profitable that you can absorb downward pressure on coal and other bulk commodity rates? And second, what would be the impact of this on your earnings and on non-coal shippers, such as grain shippers?

Mr. LEWIS. Well, first of all, I think you have to look at this business like any other business. You have to have more money coming in than is going out. And if you are asking me, can the Union Pacific cut our capital expenditures by $250 million a year for four years and absorb a billion dollars in cost reductions for bulk shippers, the answer is yes.

The other side of that is, if we get in that situation, where are we as a railroad? We are going to have—I remember when I started here in 1980, when they had standing derailments on Conrail. If we do that, we are not going to operate as a railroad.

One thing that the Staggers Act has done is it has given us the freedom of the market, and railroads have just changed tremendously in the last eight years. It is just a different business. We think in terms of customers, we think in terms of keeping them competitive.

The bottom line is, if you want to put the pressure on us, yes, I can drop my rates to anybody, but ultimately I have to somehow on the Union Pacific Railroad make $500 to $600 million a year to keep the railroad going. And if I do not, what I do is what was just said: I just cut my costs and get out of the railroad business. I spin out lines to shippers and figure out how I bail out.

I am a hired hand at the Union Pacific, not a principal shareholder. My obligation is to figure out how we keep the business going. You cannot keep it going if you end up reducing these rates.

And you look at things like coal, for example. And I said this at breakfast today, which I guess is something that I should not repeat before this committee, but you look at coal slurry pipelines and all those things we fought for years. They cannot make it. There is no way that a coal slurry pipeline can compete with the Burlington Northern and the Union Pacific in getting coal out of the Powder River Basin.

Our rates are so darn low now, we are not making enough money to support it. And if you drop those any lower, what we are going to do is we are going to cut out Senator Exon's shippers and some of yours in terms of grain coming out of your state, because we are going to have to raise the rates. And we will lose the revenue and it is going to go to trucking or something else.

Senator McCAIN. If the gentleman will yield.

Does that mean you now drop your opposition to coal slurry pipelines?

Mr. LEWIS. No, I am not allowed to do that. That is why I said I should not say it.

Mr. GASKINS. The Burlington Northern dropped their opposition last year, Senator.

Senator PRESSLER. I think my red light is on, so I shall yield to my colleague.

Senator ROCKEFELLER. Senator Danforth.

Senator DANFORTH. I think that particularly Mr. Lewis has pretty well made the point. I take it everyone agrees that your view is that the railroad business is not a particularly good business to be in, and that, but for the Staggers Act, it would be a much worse business to be in. And if the CURE legislation were passed, it would be a worse business to be in.

I think Drew Lewis has made that very clear. But I take it that is the thrust of what all of you are saying, is that right?

Mr. McKINNON. Senator, basically I agree. But one thing I would add, and maybe this is prejudice on my part since I have spent my life in it. I think it can be a good business if we address all these the problems that Mr. Dempsey has mentioned: FELA, railroad retirement, some of these labor issues.

I am satisfied that it is not a good business to be in today, and it would be much worse if we pass the kind of legislation that has been suggested.

Senator **Danforth**. Does anybody else want to comment?

Mr. **Snow**. I would just say that I agree. And just to put a point on it, we hear a lot of talk about adequate revenue levels and cost of capital as if it is an abstract, disembodied kind of concept that does not have much application to the real world, something the ICC deals with.

The fact of the matter is, every day railroads are making decisions to invest in locomotives, track, bridges, rolling stock, and so on. If the expected return from the investment does not cover the cost of capital that we have to pay to attract the capital into the business, then we do not make the investment.

And the record indicates that we are disinvesting. So what you say, what you ask us is, will the revisions of the Staggers Act as suggested by CURE adversely affect the prospects for an already troubled industry? The answer seems to me to be unequivocally yes, it has to.

Mr. **Lewis**. Senator, could I just make one comment on that? I think—I went through deregulation with you on airlines, and Senator Packwood on communications and also airlines and trucking and so forth. I think you have got to give this a chance to work.

And if it does not work and you are unhappy with the ICC, give them the power and insist that they enforce what you want to have happen. Do not you get into the business. I mean, we have got enough problems trying to run our own business. Let us not get Congress involved in it in any further way.

Senator **Danforth**. Let me ask you about the captive shipper situation. I hear what various witnesses have said, at least a couple of you have said. You say, well, we do not have captive shippers.

And I hear that, and I suppose that anybody who has a mule and a pack on its back has some form of transporting whatever he wants to transport. But I really do not think that that is a position that you would sell easily to any of us.

I mean, we would view a person who has got a coal mine out at the end of the valley or something, that would be a captive shipper. And I think Congress is concerned about the situation of captive shippers. We do believe that there is such a thing as a captive shipper, and we are concerned that wherever there is a captive shipper then by definition there is not competition, and those people are likely to pay exhorbitant rates to transport what they want to transport.

Other than opening up the Staggers Act, other than getting into CURE legislation, do you have any words of wisdom for what we should do or what the ICC should do? Or is your position that there are not any such people and there really is not a problem?

Mr. **Gaskins**. I would like to comment first that the ICC has made some rate decisions that we talked about before today that have addressed these specific problems. But more importantly, I think the economy is responding in a way that is tending to mitigate against this captivity. And let me give you a clear example.

Mr. Lewis before indicated that his railroad has a very strong position, if not captivity, with respect to soda ash shipments. Recently, we developed a truck reload operation that got into that soda ash business, and we currently move ten percent of the soda ash that was formerly judged to be captive on his railroad or at least could be judged to be captive on his railroad.

That kind of thing is going on all over the place. We are trucking lumber out of Canada. That stirred up the Canadian railroads and they are asking for some changes in their regulations. Other railroads are trucking things out of our territory.

The market is responding in a way that is going to take an awful lot of the edge off of the captivity, if you refer to captivity as having only one railroad serving you. The world is getting a lot more competitive.

In addition, the Commission is there and they have made some decisions, much to the detriment of my shareholders in recent days, to address those captive issues.

Mr. **Lewis**. Senator, one comment from my standpoint. We operate the Missouri Pacific in your territory and obviously Union Pacific in Mr. Exon's. If you have any complaints in terms of people in that territory that think we are gouging them in terms of rates as captive shippers, I will meet with them personally.

And at that point, if they object to what we are doing, let them go to the ICC and complain, and we will determine whether we are gouging them or not. We are satisfied to meet with these people. We want to be competitive.

What we are trying to do is compete with other modes of transportation. The barges on the Mississippi, where we subsidize the locks and dams, we went through that in Transportation. We are trying to compete with trucks, where we buy the highways.

And obviously they say, well, you paid for our right of way. But you look at the thing in balance. If you have complaints, tell us. We are not getting them.

Mr. **Snow**. Senator, I would say the same thing. I spend a great deal of time with our coal shippers. Coal is the heart of the CSX railroad, as Senator Rockefeller knows so well. And virtually every major coal shipper I talk to says, we are working things out.

They are not always satisfied, but we are working things out. There is a spirit of cooperation, I think, between the coal shippers and the rails—and this is really a coal industry, utility industry struggle. They are the principal critics we have.

But more and more, I think there is an attitude of cooperation, a let us work this thing out without legislation attitude, because we all want to salvage the fundamental values of the Staggers Act, the healthier industry and contracts.

Today 60 percent of our coal moves under contracts. Most of our grain and steel moves under contracts. We are basically in an auction market today in the railroad industry, with the lowest bidder winning the traffic.

Major companies put up, the utilities put up, their coal traffic to bid. Steel companies put up their steel and scrap to bid. It is a bid market. Contracts work. It is a more competitive market.

I understand the problem with captive shippers, but I would adhere to what Drew Lewis said. I think we are working it out through dialogue with shippers, with the NIT League sort of negotiations that Bill Dempsey led a year and a half ago, through individual negotiations and discussions with coal companies and with utilities.

Senator, I do not think the fight is nearly as intense when you get out and talk to the great body of our shippers as it sometimes is suggested here in the hearing rooms of the Congressional office buildings.

Mr. McKINNON. Senator, I would add one thing to that. I think, accepting your view that the man who only has one railroad to serve him is in a sense captive, the competitive marketplace may give him a position similar to others, but he is captive in that sense.

But we commissioned a study for use in one of the only rate cases we have pending at the ICC, so it was paid for by the railroads, but a study by Dr. Dennis Carlton, professor of business economics at the University of Chicago, of just what has been the effect of that captivity in our coal markets where we and the CSX and to some extent Conrail are directly competitive, in the export coal markets.

And Professor Carlton's study showed that the prices paid to ship export coal from mines served by one railroad—these are his words—"are virtually indistinguishable from rates charged to ship export coal from mines served by two railroads. '

On Norfolk Southern, there was only a one percent difference between the man who had one-railroad service and the man who had two-railroad service. And I understand the results of the study on CSX were similar.

Professor Carlton concluded: "The economic interpretation of these results is that effective competition in effect restrains rates for export coal." So the marketplace is working there, and the study we made showed that.

We would be glad to submit that to you. It has been submitted to the ICC, if you would like to have it.

Senator DANFORTH. I think that would be very helpful.

Thank you, Mr. Chairman.

Senator EXON (presiding). Thank you.

I would be happy to recognize my good friend from Arizona at the end of the table, not a member of this subcommittee, but we are delighted that he is here, and he is a very important member of our overall committee. Senator McCain.

Senator McCAIN. Thank you, Mr. Chairman.

I am very interested in this issue and I appreciate the indulgence of the chair in allowing me just to make a comment and ask one question.

Gentlemen, I am somewhat disappointed that you do not have a better handle on this railroad retirement issue. I agree with what was said by one of the witnesses. I think it is a crisis of the proportions of the social security crisis that we faced a few years ago.

And unless we receive some kind of an input from you, I do not believe we are going to have a complete answer. In fact, I predict that we will end up with this issue in the lap of the Congress to try to come up with some solution. So I would urge you to hasten as you address this issue.

Mr. Snow. Senator, could I just respond to that. The industry has submitted a letter to the committee in which we recognize the seriousness of the problem and ask that we be given until, I think it is, early next year, February, to work with rail labor to try and design some answers and fixes for this serious problem.

That effort has already gotten under way. We are not asleep at the switch on it. I understand your concern that we are not moving faster, but a major effort is under way.

Senator McCain. Thank you.

One of the criticisms concerning the belief that there will be a lack of competitiveness in your industry is the continued consolidations and mergers. The only question I would have for the witnesses is, I guess starting with Mr. Gaskins, do you believe that the Santa Fe-Southern Pacific merger is healthy for the industry or will be damaging to competition?

Mr. Gaskins. Well, the proposal that is before the Commission at the present time I think would not be good for the railroad industry as a whole, for the public interest, or for the Burlington Northern.

Senator McCain. Why not?

Mr. Gaskins. Well, the first thing I must say is that it is a quite different proposal from what the Commission originally examined in some detail, because of some railroad deals that have been made in recent times. Our preliminary analysis of those deals indicate that we would lose a fair amount of business, and that the competitive balance in the western part of the United States would not be aided by the merger.

Senator McCain. Perhaps you could supply for the record a more detailed analysis, if you would.

Mr. Gaskins. I would be pleased to do that.

[The following information was subsequently received for the record:]

BN is opposed to the SFSP petition to reopen the October 10 decision denying the merger. The agreement SFSP has negotiated with UP, DRGW and MKT do not ameliorate the anticompetitive problems which the Commission found to exist with the original plan of merger. There is no material error in the Commission's decision. SFSP has tendered no new evidence supporting its reversal in position that the UP and DRGW conditions will substantially undermine the benefits of the merger. There are no substantially changed circumstances justifying reopening. The only change which has occurred is a change in heart by SFSP—that the UP and DRGW market extensions that were previously deal-breakers are now entirely acceptable conditions which will substantially improve the anticompetitive impacts of the proposed merger. SFSP has not met the reopening standards of the ICC.

Should the Commission nonetheless decide to reopen the proceeding, SFSP and its new merger partners should be required to file a new application using 1985 data. The competitive consequences of this new plan of merger extend well beyond those competitive issues analyzed by the Commission in the first proceeding. According to a preliminary BN consultant's report by ALK Associates, the conditioned merger would cost SFSP a net loss in revenues of $284 million while putting approximately $169 million in net traffic gains in the pocket of UP. The Commission will need to provide parties with the opportunity to analyze the substantial effects of this merger together with the cumulative or synergistic impacts of the UP acquisition of MKT. BN's preliminary consultant's report indicates that SFSP would lose additional revenue of $57 million to UP if its acquisition of MKT is approved. The expedited schedule proposed by SPSP would be wholly inadequate under present circumstances.

Senator McCain. Mr. Lewis.

Mr. LEWIS. My comment would be we would have support it as it was originally supported and will support it as it is now. And my concern is that all of us who are, let us say, the large railroads you see here, are faced with very serious union problems.

Not union problems in the sense that the unions are not cooperative, but in the sense that we have to work together to solve our problems. I think the Southern Pacific is a relatively weak railroad and, without a merger, there can be serious implications in terms of service in that general area if the Southern Pacific for some reason is not able to survive.

Therefore, from our standpoint we would have accepted it originally as it was. We would rather have a good, tough, strong competitor than somebody floundering around or selling off branch lines and going non-union when we are operating in a totally different atmosphere.

And so we would recommend it goes through. We are now trying to go through with a merger with the Katy. In every case, we are going to assure the Commission that there are at least two lines serving the people that are part of the present Katy system.

But if we do not acquire the Katy, which we may or may not be able to depending upon what the ICC does, the Katy cannot survive. Someone else is going to have to buy them. And again, if we are going to have a good rail system in this country, we are going to end up with fewer railroads.

And I said this when I was Secretary of Transportation. When push comes to shove, this country is going to end up with six railroads that are really dominating the business, with a lot of short lines feeding it. And that is where we are heading. It is just a matter of when we get there. And my position has not changed since before I was in the business and since I am in the business.

Senator MCCAIN. Does Mr. McKinnon or Mr. Snow have a comment?

Mr. MCKINNON. We have not been a party to that case, Senator, since all of our activities are on this side of the Mississippi. And I could not comment on the interrelationship of the various conditions that have been negotiated or might be imposed.

The only thing I would say is that I do see that there is an overcapacity problem in the West today, that until there is a solution you will have the kind of problems that Mr. Lewis mentioned, of a weak railroad having to dispose of its parts in a way that probably is not beneficial to the health of the industry.

Senator MCCAIN. Thank you for your courtesy, Mr. Chairman.

Senator EXON. Thank you, Senator McCain. You are very welcome.

Gentlemen, I apologize for being called away. I am going to be brief with my questions. Let me just make a general comment.

Despite the ad that I saw in the Washington Post newspaper, this morning, with regard to the tree that was being all chopped up by the CURE bill, which I thought was—I do not know whether Herblock drew that cartoon or not, but it was his type.

I can only speak for myself, but I think generally I have the mood and sense of most of my colleagues. The Staggers Rail Act has been a good thing. I do not believe that we are out to change that.

I suspect that maybe this oversight hearing would not be necessary today had the ICC done the job that I think was intended when the Staggers Act passed. And we are going to continue to review that.

Mr. Lewis, I notice very much your statement about wanting captive shippers or those who feel they have been aggrieved to come to the railroads. I think that is a good suggestion, and I think possibly that has helped a great deal.

I would certainly say that, from my experience from the beginning of the Staggers Act, as far as Nebraska at least is concerned, that we have had a steadily decreasing number of complaints with regard to captive shippers. I do not know what the reason for that is, but I suspect the reason for it is there has been a general understanding and agreement, while not always specifically agreeing on every issue. I think there have been attitudes by all that we are trying to make this thing work, the thing being the Staggers Act.

I come back to my point, that maybe the ICC is not addressing the Staggers Act the way that I think the Congress intended when it was passed, with regard to certain parts including captive shippers. This is the reason for the hearing today.

We want to continue to work with you, and I do not believe there is any effort here to chop down half of the tree. Maybe it is proper that we have continued pressure on the ICC to make sure that the Staggers Act serves both the industry and the public as it was intended. And all that we want there is a basic balance.

I understand, Mr. Gaskins, that you gave some very interesting figures, and I appreciate that, with regard to the significant reduction since the Staggers Act with regard to the movement of agricultural products, if I remember correctly, about a 44 percent reduction.

You may not have the answer to this question, and if you do not I will understand. In my opening statement I said that is good news. Do you happen to have in any of these studies that your railroad has done or possibly your railroad, Mr. Lewis, with regard to what percentage of those savings have been passed along to the farmers, the producers?

Or do you haul the freight and let those who bear those costs work those things out among themselves? Do you have any stats on that at all?

Mr. Gaskins. We have not made a specific study of that issue, but our general understanding is that the bulk of the savings do go to the farmers. I would suggest that you might ask later witnesses, Mr. Harding for example, because we know we pass the savings on to the grain companies, and we think that in most instances competition between the grain companies is sufficient to pass that on to the farmer. So it is our general impression that that is right, but we are certainly no authority on that.

Senator Exon. Do you have any information, Mr. Lewis?

Mr. Lewis. The same. Our rates in Nebraska have gone down about 32 percent. But to what extent that is being passed on to the farmers, I cannot tell you. If you are not able to get that in further testimony, we will try to provide it.

But we do not have statistics of where the money has gone.

Senator Exon. Thank you very much.

The last question I have is a general question that I will address to any of you who care to comment on it, and then we will have a short second round of questions and then move on to our next panel.

Representatives of the coal industry, as you probably know or are about to find out, will testify later today that the railroads have obtained a 39 percent so-called improvement in productivity over the period of 1980 to 1985. They will argue, however, that they are not—that they have not received rate reductions that are in any way comparable with this.

Would you like to comment in advance of that statement that I believe we are going to hear?

Mr. LEWIS. I think the thing that you have to realize, Senator, is that at the time of the Staggers Act throughout the country—and this included Conrail, because at that point they were probably the most deteriorated railroad in the country—we were having serious problems in terms of speeds and track maintenance.

And what has happened is the railroads are making more money than they did and, regrettably, we are making it at the cost of labor. And we have lost some very fine people in the railroad because we have had to eliminate them just because we are trying to cut costs.

The labor has really financed the rebuilding of the statement, without any question. And what we are doing is we are spending more money on maintenance. And we can cut our maintenance costs and we can drop all of this down into the realm where we were in 1980.

But the point is we are putting money back into the railroads, and the facts are in our 10k, the facts are in our annual statements. And you can see it in everybody's statement to my right.

Mr. MCKINNON. Senator, I would add a couple of things. Our productivity has increased. At the same time, we have had reductions in certain costs, fuel expenses and others. Many of the fuel expenses are passed on directly to the coal receivers in the contracts we have with them.

But for example, during the 1985–86 period our transportation operating expenses, which is our rail cost for providing service, increased from $3.11 billion in 1985 to $3.37 billion in 1986. At the same time, we were negotiating every day coal rate contracts—I am familiar with many of them because I was in the marketing end of this at that time—which were reducing rates actively.

The contracts in 1986, in addition to rate reductions, they resulted in some $25 million in refunds to major receivers with whom we made those contracts. So some of our costs have gone down. Our productivity has improved. But our overall expenses have gone up. It has been a combination of functions in various expense areas, and at the same time we have been giving the rate reductions to coal customers.

Mr. GASKINS. Senator, in our case an awful lot of that productivity came from heavy investment in beefing up the railroad to handle unit coal trains and tightening up our operations and operating more efficiently. We think that we have the right to keep a large portion of the productivity gains because we were the ones that took the risks to make those investments and to change our practices to increase the productivity.

Unfortunately, because of the new competition in the Powder River Basin, we have had to give up a fair amount of that productivity. Furthermore, I am concerned for the future that, if the competition remains at the level it is, that perhaps the industry will not innovate enough in the future, because we have to pass along too much of the productivity gains immediately to our shippers. If we have to pass it all back, then we will not make the necessary investments to continue to improve our operations.

Mr. SNOW. Mr. Chairman, we are in the same position as the other gentlemen. Over this period, I mentioned earlier that CSX is in constant dollars, in real dollars, our expenses have come down 24.3 percent. But our revenues have come down 24.7 percent in real terms.

Our rates to the shippers are much lower, coal shippers included, much lower than they were in 1980 when the Staggers Act was passed. In constant dollars, from 1981 to 1986 railroad freight rates as a whole declined by about 5.1 percent. Coal rates during that period declined by 6.9 percent.

So I think the shippers are seeing, Senator, the benefits of the enhanced productivity that has come about since the Staggers Act.

Senator EXON. Thank you.

I will turn now to Senator Rockefeller for a second round. Do you have further questions?

Senator ROCKEFELLER. Just one question, one record submission, Mr. Chairman.

Maybe I would suggest this to Mr. McKinnon and Mr. Snow. You have indicated that there is some or little captive traffic. Now, in southern West Virginia and eastern Kentucky and southwestern Virginia, we would argue, I think, that 85 percent of all of the traffic out of those coal fields is captive.

And we would argue that, and it will be argued in a later panel, I believe. And I do not think these people have a great deal of choice about where their rates come from, and I do not think they would at least argue that.

Now, let me ask you something. Mr. Dempsey said last week that the biggest growth area for railroad freight is piggyback, and that is the most rapidly growing, but that in fact it was only coming in at about 112 percent of variable cost, which really barely covers costs if it does cover costs.

Mr. McKinnon, you were recently quoted as saying that piggyback is "marginally profitable at best; at current profit margins it cannot sustain itself over the long term." Again, when Mr. Dempsey testified last week he said that if rates were capped at the ICC's jurisdictional threshold the railroads would lose all their net income.

So your fastest growing part of your traffic, piggyback, cannot keep up, cannot sustain itself. It sounds to me as if your captive traffic, that which is above the statutory threshold, is providing your profit margin and is carrying your freight, including your piggyback, and perhaps in fact giving you all of your profits as an industry.

Do you agree with me or not?

Mr. McKINNON. No, sir. I said at the same time that that discussion was made that piggyback makes a contribution to our bottom line profit. It does not meet the test of sustaining new investment in that business, but it is contributing to our bottom line profit.

And I went on to say that if it is not going to find itself in a position, if the competition is such, and the competition is out there and if it remains such, that we can only haul it at a rate below our long term variable cost, we will have to drop that business.

But that does not mean that it is not contributing to the current bottom line profit. It is not contributing enough to make us make a new investment.

Coal is contributing enough to make us keep investing in that business. Coal is more profitable than piggyback. But if we give up the piggyback, you are going to have a negative effect on coal rates, because that profit that it gives, that bottom line profit without reinvestment, helps us secure the funds to make the new capital investments in coal and in the other parts, gut parts of our railroad.

I hope we can find a way—we are working on it with things like Roadrailer—to make the piggyback traffic more profitable and make it contribute a bigger share. The marketplace is what is determining that. The marketplace is also determining our coal rates.

So I do not agree with that.

Senator ROCKEFELLER. You do not agree with me that—you do say that piggyback is part of your profit picture, or do you say——

Mr. McKINNON. I say it is. The bottom line is our profit picture. It is the contribution to overhead that it is not making adequately, and it is making some contribution.

It is not making as much as it should if I was going to stay in that business. But every contribution it makes to the overhead keeps me in business. If that contribution goes away, then coal is going to have to make an even bigger contribution to overhead for us to stay in business.

Senator ROCKEFELLER. So captive shippers are not providing your profit margin?

Mr. McKINNON. The shippers you are talking about are not providing all of our profit margin, no. They are not contributing—they are contributing more to our overhead than this marginal business.

But without that marginal business which makes some contribution to overhead, we would have to seek a bigger contribution or get our of the coal business, too.

Senator ROCKEFELLER. Mr. Snow.

Mr. SNOW. We are in the same boat, Senator. And I appreciate your concern that we may be making inadvertent wrong-headed investment decisions in a new line of business in order to grow.

But at CSX, while it is not profitable, highly profitable, while the numbers you talk about, 112 percent ratio of revenue to variable cost, is about right, at least it is making some contribution to the overhead. The jury is still out on whether or not it is a sustainable business for the long term, I have to grant you that.

Senator ROCKEFELLER. Mr. Chairman, I thank you and I ask that an exchange of letters between the vice president of Conrail, Mr. William B. Newman, Junior, and Chairman John Dingell on the matter of the term "revenue adequacy" be placed in the record.

Senator EXON. Without objection, so ordered.

Senator ROCKEFELLER. I thank you, Mr. Chairman.

Senator EXON. Gentlemen, thank you very much. We appreciate your expert testimony.

And we call the next witness, a single panel, Mr. Richard Kilroy, Chairman of the Railway Labor Executives Association. Mr. Kilroy, will you please come forward and take your place at the table.

Mr. Kilroy, we welcome you and your associates, who have been here previously and I am sure will be back again. We appreciate your coming and giving us your point of view this morning, and we would ask you to proceed at this time.

STATEMENT OF RICHARD I. KILROY, CHAIRMAN, RAILWAY LABOR EXECUTIVES ASSOCIATION, ACCOMPANIED BY GEOFFREY ZEH, VICE CHAIRMAN; JAMES SNYDER, CHAIRMAN, LEGISLATIVE COMMITTEE; AND WILLIAM G. MAHONEY, COUNSEL

Mr. KILROY. Thank you, Mr. Chairman.

I am accompanied this morning by: on my right here, Geoffrey Zeh, who is President of the Brotherhood of Maintenance of Way Employes and Vice Chairman of the RLEA; and on my right, the extreme right there, Jim Snyder, Chairman of the Legislative Committee, RLEA; and on my left, William G. Mahoney, counsel for RLEA.

The Railway Labor Executives Association appreciates this opportunity to appear before you to present the views of the RLEA on matters of vital importance to every railroad employee in this nation, both active and retired. We have prepared and filed with the subcommittee a longer version of my remarks here this morning, as well as a statement of the Railway Labor Executives Association on this subject, with attached exhibits, all of which we ask be entered into the record of this proceeding.

Unfortunately, we cannot in a ten minute oral statement begin to respond in detail to the numerous railroad management and ICC witnesses who have testified at length before this subcommittee against the interests of the railroad employees of this country and, we believe, ultimately against the public interest.

The subject matter of much of what these witnesses spoke of is beyond the jurisdiction of this committee, and I will not waste the few minutes I have to answer it, except to say that, having been provided every consideration possible by the ICC in neutralizing or removing their obligations to their employees whenever the ICC has been able to do so, the railroads now wish to destroy the remaining rights of their employees as found in the Federal Employers Liability Act, the Railroad Retirement and Tax Acts, and even the Railway Labor Act.

The railroads argue that there is no way of improving their revenues, so they must cut their costs internally. They would accomplish that end with Congress' help by flaying the economic skin from the bodies of their employees.

The railroads plead poverty as justification for their continued destruction, with ICC assistance, of their employees' rights and their desire to destroy even more employee rights by Congressional elimination of those laws enacted to protect the employees', as well as the public's, interest.

However, given the railroads' history of appeals to Congress, providing them with everything they request will do no good. The railroads will return for more; again pleading poverty.

This was their plea in 1958, when they told Congress the state regulatory agencies withheld approval for political reasons of 15 percent of the passenger trains which should be discontinued. So Congress let them remove passenger trains virtually at will. This led to the removal of the 15 percent and the deterioration and destruction of the other 85 percent.

This was again the railroads' plea twelve years later, when Congress relieved them entirely of the burden of passenger service because the railroads said it cost them $700 million a year; so Congress created Amtrak.

The railroads in the Northeast said they went bankrupt because of their inability to compete with short haul trucks (now the long haul western carriers say they cannot compete with the long haul trucks), although many thought the ill-considered ICC approved mergers were to blame.

In any event, Congress responded to pleas of the railroad industry that the Northeast connections were essential to them, as well as to the country, and again saved them by creating Conrail.

Then came the Railroad Revitalization and Regulatory Reform Act of 1976, the Staggers Rail Act of 1980, and the Northeast Rail Service Act of 1981; each one designed and enacted to help the industry in response to the industry's continuing cries of poverty, as demonstrated by a claimed abnormally low rate of return.

And now they again cry poverty and seek more help—not this time for less regulation (Congress has given them that) or for removal of losing operations (Congress has removed those)—what they now seek is to have Congress aid them by continuing to let the ICC transfuse them with the economic blood of their employees and to increase the flow of the transfusions by repealing those laws which the ICC has not, as yet at least, claimed to supersede.

But it will do no good to again accede to the industry's wishes. They will return. According to their spokesmen, the situation of the industry never improves no matter what is done by the Congress and the Commission and—yes, even the employees.

For the working men and women of that industry have given and given and given over the past decade in terms of work rules and wage concessions, and jobs—hundreds of thousands of jobs have gone to outside contractors and short line operators, to line abandonments and mergers and common control approvals such as CSX and Norfolk Southern.

The Staggers Act line abandonment provisions were designed to aid the railroads in quickly abandoning 15 to 18 percent of the lines for which there was no need—this is reminiscent of the railroads 1958 claimed desire to remove 15 percent of passenger trains which were unneeded—however, as in the case of the passenger trains, the 15 percent has been reached and surpassed and, together with the sales to short lines (which, incidentally are often financed and manned by the selling carrier's money and "retired" officers—are reducing our Class I rail network very quickly and to an alarming, and we believe potentially disastrous, degree.

By their very nature, their existence is tenuous. The March 16, 1987, issue of the "Short Line Reporter," an industry publication providing analyses of short line railroads, stated "that of 138 regional or short line startups last year, 29 failed."

That failure rate is an alarming 21 percent. What will happen to the short-line industry if a deep, prolonged recession occurs as some economists predict for 1989? We believe it will almost disappear.

As the law is now written it could disappear in 30 days and no one, not even this Congress, could prevent it. But those 29 failures show something else. At the very least, those 29 lines should have been abandoned in the first place.

Had they been abandoned, the affected employees and their families would have been protected by the mandatory protection the Congress required to be applied in abandonment cases. Since the lines were not abandoned, but sold to paper companies under an ICC regulation by which no employee protection will ever be imposed, the affected employees and their families were left with nothing.

Where short lines have, thus far at least, been successful, that success is due in no small part to the subsidies provided by their employees in terms of substandard wages and working conditions, as well as by the employees of the selling carriers who have been deprived of the statutory protections which, prior to 1982, they had been consistently and historically provided.

We ask you to look at the unchallengeable record which we submit to you today in our prepared statement. We ask only that you restore, belatedly as it may be, the rights which the ICC and the railroads have stripped from the employees since 1982.

We ask only that the railroad employees and their families not be made the deep pockets for the present day railroad managers as they and the consumers of this nation were in the last quarter of the last century.

The language of the Staggers Rail Act was designed to protect employees. That Act contains nine separate provisions for employee protection. The short line phenomena was not considered by Congress when it enacted Staggers, but was the result of creative imagination at the ICC and in the industry.

It has not only been extremely injurious to railroad employees, but threatens the integrity of our national railroad network. The amendments we offer as Exhibit "N" to our prepared testimony do not amend the Staggers Act and do not reregulate transportation. They would re-establish the Railway Labor Act and protection right of employees that they enjoyed prior to 1982, and which were unilaterally stripped from them by the Interstate Commerce Commission as a "deregulation move in the spirit of Staggers."

Thank you. I would be happy to answer any questions which you, Mr. Chairman, or any members of the committee may have.

[The statement and questions and answers follow:]

STATEMENT OF R.I. KILROY, CHAIRMAN RAILWAY LABOR EXECUTIVES' ASSOCIATION [1]

My name is Richard I. Kilroy. I am the Chairman of the Railway Labor Executives' Association and President of the Brotherhood of Railway and Airline Clerks. My office is located at 3 Research Place, Rockville, Maryland. On behalf of the nation's railroad employees whom we represent, I would like to present to you our view on the need for the Congress to act and act now to restrain the high-handed manner in which the Interstate Commerce Commission reversed its traditional interpretation and application of the Interstate Commerce Act to railroad employees since that Act was amended by enactment of the Staggers Act.

The House of Representatives reviewed this matter only last year and in September enacted amendments similar, and indeed in some respects identical, to those we support here. The Senate conferees, however, at that time refused to discuss them as part of the Conrail Sale bill and the amendments were dropped from that bill in conference in order to secure enactment of the Conrail sale bill.

As a result, the Commission has become bolder and many more thousands of employees have been deprived of their employment, their compensation protection and their Railway Labor Act and collective bargaining agreement rights.

The Railway Labor Executives' Association is an unincorporated association with which are affiliated the chief executive officers of virtually all of the standard national and international labor unions which represent railroad employees in the United States.

On June 8, 1987, the Supreme Court vacated the decision of a lower court which had held that the Interstate Commerce Commission had to make a finding that exemption from other laws was "necessary" to carry out a "transaction" approved by the I.C.C. Five of the Justices held the lower court to have had no jurisdiction because of a procedural technicality but four Justices concluded that the lower court had jurisdiction but should be reversed because the statutory exemption was automatic and the I.C.C. had to make no "necessity" findings.

If the exemption is automatic with regard to the Railway Labor Act, it is automatic with regard to every statutory law contained in the federal and state codes. And the Commission has held, as have the arbitrators appointed to determine disputes under its ironically named "employee protective" conditions, that though a change in operations, services or facilities adversly affecting employees may occur years after the Commission's order approving a merger or control case has been fully executed by the railroads, that change is automatically exempt from any restrictions imposed by collective bargaining agreements or the provisions of the Railway Labor Act.

In light of the dangerous turn the Commission's unilateral deregulation of the railroads' obligations to their employees has taken, we pose three questions for the consideration of this Subcommittee and the Congress:

1. When the Congress authorized the Commission to impose in its discretion conditions for the protection of the interests of railroad employees in certain Sections of the Staggers Rail Act, did it intend that the Commission should *never* exercise that discretion to protect employee interests?

The Commission has answered this question in the affirmative:

"We . . . reaffirm . . . our long-standing and judicially approved policy of not imposing labor protective conditions on acquisitions and operations under section 10901 . . . . [W]e will not impose labor protection even on established carriers acquiring or operating such lines. . . . [W]e would not impose protective conditions if an application or individual exemption were filed."

The U.S. Court of Appeals for the D.C. Circuit recently affirmed this holding of the I.C.C.

2. In enacting the Staggers Rail Act, did the Congress intend to transfer the goverance of labor relations in the railroad industry from the Railway Labor Act, the National Mediation Board and the National Railroad Adjustment Board to the Interstate Commerce Act and the Interstate Commerce Commission?

The Commission has answered this question in the affirmative:

"It is that [Commission] order, not the RLA [Railway Labor Act] or WJPA [Washington Job Protective Agreement—a contract between the railroads and the unions], that is to govern employee-management relations in connection with the approved transaction."

The arbitrators agree.

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[1] The attachments to this statement were not reproducible and are in the Committee files.

A third issue surfaced in the December 24, 1985 decision of the Commission approving the purchase of some 650 miles of Illinois Central Gulf Railroad line in Iowa by the Chicago, Central & Pacific Railroad Company. The latter railroad was created to purchase and operate the line and is owned by Mr. John Haley who also owns the Valley Railroad Company.

The Interstate Commerce Act provides that when an individual owns one railroad and wishes to purchase another railroad he *must* apply for I.C.C. approval under Section 11343 of the Act. Section 11347 mandates that the Commission *must* impose employee protective conditions upon every approval order issued under Section 11343. Of course, Mr. Haley could have sought relief from the requirements of Section 11343 by applying for an exemption under Section 10505 of the Act. These exemptions are liberally allowed by the Commission. However, Section 10505 empowers the Commission to exempt applicants from every provision of the Interstate Commerce Act *except* Section 11347 and similar provisions found in the Act requiring employee protection.

Consequently, instead of seeking an exemption under Section 10505, Mr. Haley placed his Cedar Valley Railroad stock *in a voting trust* to commence with the filing of Mr. Haley's purchase application under Section 10901—knowing the Commission has stated that it will never impose employee protective conditions under that provision of law—and to terminate immediately upon the Commission's approval of the purchase.

This evasion of the employee protective requirements of the Interstate Commerce Act was challenged as such by the RLEA and was acknowledged to be such by the Commission. Yet, the Commission approved it simply because its members and staff oppose providing employee protection even in the face of a Congressional direction to do so.

The third issue, therefore, is as follows:

3. Whether the Congress intended the mandatory employee protection requirements of Sections 11343 and 11347 to be evaded by the expedient of a temporary voting trust arrangement specifically designed to accomplish that evasion?

As noted above, the Commission has also answered this question in the affirmative.

It is today a supreme irony that the commonly understood most effective way to *avoid* employee protection is to file an application with the I.C.C. (See Exhibit "J" attached to the RLEA Statement.)

These policy statements and positions of the Commission are completely irreconcilable with its own pre-Staggers Rail Act positions and statements of policy; with the traditional treatment of railroad employee interests by this Congress in Staggers and earlier legislation; and, they contradict the rationales of all holdings of the Supreme Court under earlier statutes.

Rail labor finds such a policy intolerable and incompatible with continued peaceful labor relations in the railroad industry which, as the Supreme Court long ago noted, are endangered when employees are deprived of just treatment.

We are submitting for the record along with this statement a "Statement of the Railway Labor Executives' Association on Staggers Rail Act Oversight" which details, with supporting exhibits, the history of employee protection in the railroad industry before the Congress, the Courts and the Commission, prior to Staggers; Congress' extensive protection of employee interests in Staggers; and the present Commission's defiance of that tradition by the blatant arrogation to itself of policy determinations restricted to the Congress by the Constitution. The Commission statements quoted above appear at pages 40–41, and 50, respectively, of the "Statement" and its statements on the use of voting trusts to evade the employee protection requirements of the law are set forth in Exhibits "G", "H" and "I" attached to the "Statement". Also attached as Exhibit "N" to the Statement is a one-page amendment to the Interstate Commerce Act proposed by RLEA and a five-page section-by-section analysis and explanation of the proposed amendment.

The railroads of this country, having been provided every consideration possible by the I.C.C. in removing or neutralizing their obligations to their employees whenever it has been able to do so, now wish to destroy the remaining rights of their employees as found in the Federal Employers Liability Act, the Railroad Retirement and Tax Acts and possibly even the Railway Labor Act. As Mr. Dempsey has testified, the railroads see no means of improving their revenues so they must cut their costs and that means they must continue flaying the economic skin from the bodies of their employees.

The railroads have testified they must be freed from the burdens of the Federal Employers' Liability Act. Such freedom according to Mr. Drew Lewis would make very optimistic the outlook for the industry. But the railroads say they will save only $100 million a year by repeal of F.E.L.A. Will $100 million save the industry in 1987 when $700 million (removal of passenger service obligations) could not save it in 1970? Will the removal of the employees' pension system save the railroads? The railroad officials contend it will but do not say how it will.

Over the past ten years the railroad employees of this nation have given and given and given in terms of work rules and wage concessions and, indeed jobs. The carriers have continued to contract out work and sell off lines resulting in fewer and fewer jobs in the industry. For some time many of the managers of our railroads have looked *only* at the bottom line of their financial statements to the exclusion of virtually every other aspect of their railroads. We believe that such tunnel vision is dangerous. For example, Mr. Hughes testified that the one hundred mile day in effect on his railroad, the Bangor and Aroostook, meant that at 50 miles per hour his employees made a day's wage every two hours. Mr. Hughes must know that is rubbish or else he has no idea how his, or any other, railroad operates. Because of the numerous stops and delays in the course of a day's work a crew is often lucky if it can make 100 miles without violating the hours of service law. Also, there is being created in this country a two-tier type of rail network made up of single high-density main lines and hundreds of so-called short lines and regional railroads. Many of those short lines were financed with seed money from the railroads which sold them the rail lines; many are operated by former middle level managers of the selling railroads who "retired" in order to run the new short lines. Virtually all of them were created solely to buy or lease the railroad lines involved. Almost none has a financial foundation sufficient to withstand a prolonged recession—the type of recession which some economists are predicting for 1989. Every one of these short lines could abandon operations on 30 days' notice if the going got tough. If they did so no one could do anything about it, including, unfortunately, the Congress, unless the Congress wanted to buy the lines in order to preserve our rail system.

By devices such as sales of lines and contracting out of railroad work the industry has jeopardized the Railroad Retirement System, and now seeks to eliminate that law and almost all laws enacted by the Congress to protect the interests of railroad employees.

Given the railroads' history of appeals to the Congress, giving them everthing they request will do no good. The railroad industry will return for more, again pleading as justification that their rate of return on investment is the lowest in the nation, if not the world. This was their plea in 1958 when the railroads told the Congress they must be rid of 15% of the passenger trains then operating which they contended cost them hundreds of millions of dollars a year but which the States would not let them discontinue and Congress answered by passing the 1958 Transportation Act allowing passenger trains to be discontinued almost at will; twelve years later when our rail passenger service had become a national disgrace, the railroads told the Congress their rate of return was exceedingly low and passenger service cost them $700 million a year and they must be rid of it and Congress complied and created Amtrak; just three years after that, thanks primarily to the I.C.C.'s ill-considered approval of mergers which should never have occurred but, according to the railroads, due to the short-haul competition of the trucks in the Northeast with which the railroads could not compete, Congress and the taxpayers again had to respond and did so with the creation of Conrail; the Railroad Revitalization and Regulatory Reform Act of 1976, the Staggers Rail Act of 1980, the Northeast Rail Service Act of 1981, all designed and enacted to help the industry in answer to its cries of an abnormally low rate of return. And still they come with claims of low return and the need for more and more help. But now they do not call for less regulation (Congress has given them that) nor do they seek the removal of losing operations (Congress has removed those); now they seek to have Congress aid them in sacrificing their employees on the alter of return rates by having the Congress remove from the books the only law which effectively protects employees in some of the most dangerous work in the country, the Federal Employers Liability Act; their pension system; the protections which the Congress has made mandatory in abandonment, merger and similar cases (the I.C.C. has declared it will never again exercise its discretion to impose "fair and equitable arrangements" for the protection of employees); and, I am sure, the railroads will seek repeal of the Railroad Unemployment insurance system and the Railway Labor Act as soon as they consider the timing and cost advantages to be "right".

The song never ends. No industry in this nation has received the consistent positive response of Congress to its pleas and apparently has done less with it. The situation of the industry—so its spokesmen claim—never improves no matter what is done by the Congress and the Commission and, yes the employees, to aid that situation.

To consider giving to the railroads further transfusions using the blood of their employees, we believe to be not only short-sighted and immoral, but useless as history demonstrates that no matter what the Congress does for the industry, it will return again waving its low comparative rate of return and pleading for more help from the Congress.

R. I. KILROY, Chairman
J. J. KENNEDY, JR., National Legislative Director
G. N. ZEH, Vice Chairman

(202) 737-1541

RLEA
RAILWAY LABOR EXECUTIVES' ASSOCIATION
RAILWAY LABOR BUILDING, 400 1st ST., N. W., WASHINGTON, D. C. 20001

July 17, 1987

Honorable Ernest F. Hollings, Chairman
Committee on Commerce, Science and Transportation
United States Senate
Washington, D.C. 20510-6125

Re: Hearings on Legislative Proposals Affecting
the Railroad Industry and the Staggers Rail Act

Dear Mr. Chairman:

This is in reply to your letter of July 2, 1987, with which you enclosed three questions for our response. Set forth below are the questions you submitted and our answers:

Question 1: The I.C.C. has exempted line sales to shortline and regional railroads from labor protection requirements. These railroads have testified, however, that in the majority of these sales, the new carriers operate as unionized railroads with newly-negotiated labor agreements. In your opinion, is this correct? How do you assess the actual impact on railroad workers of the ICC's failure to impose labor protection in these transactions?

Answer: While we have no precise statistics on the subject of the number of "unionized railroads with newly-negotiated labor agreements", we doubt the statement to be correct. We know that a number of the newly formed short lines are very small with very few employees and have no collectively bargained agreements. We know that a number of the larger railroads such as the Dakota, Minnesota & Eastern, created from lines of the Chicago & Northwestern, threatened the employees of the Chicago & Northwestern from whom it was buying the lines with refusal to be considered for employment with DM&E unless they resigned from their employment with C&NW and waived all claims against that employer. DM&E representatives (who were former C&NW officials) boasted that the new railroad operation would be a non-union operation.

AFFILIATED ORGANIZATIONS: American Railway Supervisors' Association, Division of BRAC • American Train Dispatchers' Association • Brotherhood of Locomotive Engineers • Brotherhood of Maintenance of Way Employes • Brotherhood of Railroad Signalmen • Brotherhood of Railway Carmen, Division of BRAC • Brotherhood of Railway, Airline & Steamship Clerks • Hotel Employees and Restaurant Employees International Union • International Brotherhood of Boilermakers, Iron Ship Builders, Blacksmiths, Forgers & Helpers • International Brotherhood of Electrical Workers • International Brotherhood of Firemen & Oilers • International Longshoremen's Association • National Marine Engineers' Beneficial Association • Railroad Yardmasters of America, Department of UTU • Seafarers' International Union of North America • Sheet Metal Workers' International Association • Transport Workers Union of America • United Transportation Union

Some short lines have been developed from pre-existing tiny railroads with a union contract with one union at substandard rates and rules for the very few employees they have employed. When additional lines are acquired by purchase or lease, the short lines refuse all negotiation with the representatives of the affected employees taking the position those employees are now subject to an existing contract even though that contract was neither intended nor designed for the type of operations the short line now maintains.

It would be instructive if the Regional Railroad Association would supply this Committee with the names and number of employees on each of its members which have no contract and those which have a contract as well as copies of those contracts. Only they have the facts and can readily supply them.

The I.C.C.'s reversal of policy, interpretation and application of the provisions of Section 10901 "in the spirit of Staggers" insofar as the rights and interests of employees are concerned has visited enormous, unnecessary hardship upon those employees and their families.

By removing employee protective conditions from the scheme of sales of railroad lines to paper corporations and by sanctioning the creation of temporary voting trusts of railroad properties by their owners until those owners can create new paper corporations to purchase other railroad lines thereby evading the mandatory employee protection requirements of Sections 11343 and 11347 of the Interstate Commerce Act, the I.C.C. has informed the railroad managers of this country that they are free to ignore the seniority and other rights the affected employees have had throughout their railroad lives. To think that the rights of employees will not be trodden under in such circumstances is unrealistic. The principals involved in these sales are businesses interested in profit. While the profit motive, of course, is the basis of our economic system and is not evil in itself, it can rather quickly degenerate into unbridled greed which is evil and is most injurious to the public interest and the public welfare unless it is tempered by other concerns for the public interest and the public welfare . Total concentration on the "bottom line" to the exclusion of all other considerations which appears so clearly to be the driving force in business today, certainly in railroad business, does not encourage social conciousness nor an equity ethnic in dealing with the employees who for many years performed the work in connection with the lines sold.

If one believes these statements to be in the least exaggerated, let him read the decision of the I.C.C. in the Southern Ry.--Central of Georgia --Control case in 1967 when one railroad took advantage of an inadvertent error by the Commission in approving that railroad's control of another railroad and brutally mistreated the employees of the second railroad. After five years of litigation culminating in a remand to the I.C.C. from the Supreme Court and an eight-week hearing before the I.C.C. during which 206 mistreated employees testified, that agency concluded that the railroad, thinking it could ignore the seniority rights of the employees because of the Commission's error, had "callously disregarded the established rights and interests of the employees . . . and that the undertaking of acquiring control of Central was made with very little, if any, regard for the interests of any employees who were expected to be adversely affected by the transaction". (331 I.C.C. at 185.)

Lest one think management treatment of unprotected employee interests has changed since 1967, let him review the record of the Dakota, Minnesota & Eastern purchase from the Chicago & Northwestern.

An additional significant reason which supports the need for just and equitable protections for railroad employees at this time and which emphasizes the insensitivity of those who have deprived employees of their traditional protections is found in the fact that the railroad work force of this country is today a much older work force than it was six or seven years ago due to the precipitous drop in railroad employment over that period of time. The employees at the bottom of the rosters today have anywhere from 15 to 20 years or more of service. They are too old to obtain other employment; they have unsaleable skills in many cases; and, they are too young to retire. Often, as in the case of many of the employees affected by the Dakota, Minnesota and Eastern purchase, they live in sparsely settled areas where there is no other work. In short, they are hit harder, much harder than the great majority of employees normally hurt in non-railroad industrial layoffs; and, most significantly, these employees have worked for many years with the knowledge that in the event of the sale or abandonment of the line for which they work, they would be protected. The I.C.C. took that protection away from them in 1982 without a change in the law governing the protection of employee interests.

Question 2: Do you have a proposed solution to the concerns you have expressed in the area of labor protection?

Answer: The solution we propose is attached to this response in the form of an amendment to the Interstate Commerce Act which would not restore all of the protection taken from the employees by the I.C.C. in cases involving sales of lines but only about 10% of the value of that protection and would give the employees who have been engaged in performing work in connection with the purchased line the right of first hire to the jobs which the new owner of the line decides to establish. This seems only just since this is the very work they have always performed and since most of these employees otherwise would have no hope of continued employment for reasons stated above, and particularly because new employers generally do not want to hire older employees.

The amendment would also restore our National Rail Labor Policy to an equal footing with our National Transportation Policy as it was prior to the latter part of 1981 when the I.C.C. decided that its orders not the Railway Labor Act, or collective bargaining agreements "govern employee-management relations in connection with an approved transaction". (See RLEA Statement of June 17, 1987, before the Committee at page 50, on file with the Committee.)

Question 3: It seems that one of the biggest potential areas of concern for railroads and railroad workers lies in the area of retirement benefits, where there are now three retirees for every one active rail worker. This poses the potential of increasing financial burdens for both industry and workers. Do you have any views or proposals regarding this?

Answer: The basic problem with the Railroad Retirement System is that it is based upon the number of employees in active service and the railroads have been and continue to be engaged in an aggressive campaign to reduce that number at any cost through contracting railroad work to non-railroad firms, sales, abandonments, mergers, etc. The problem could be solved by using another criterion as a revenue base such as gross revenue, ton miles, etc.

In any event, Labor and Management have found solutions to problems in the system which have arisen in the past and we are confident it can be done for the future. It is significant to note here that the system is in no immediate danger and there is no need for action on this subject by the Congress in the near future.

I trust that the foregoing adequately responds to your inquiries and is helpful to you. Should you or your staff have any further questions, please do not hestitate to contact me or our counsel, Mr. William G. Mahoney, (301) 593-2773.

Respectfully,

R. I. Kilroy

R. I. Kilroy, Chairman

Senator Exon. Mr. Kilroy, thank you very much.

Let us get into some questions that I think are important on this. Seven or eight years after the fact, how do you view the overall intended success of the Staggers Act on a scale of one to ten, one being the lowest rating and ten being the highest rating, from an overall standpoint, not just labor?

How far did the Act go in doing what it was designed to do?

Mr. Kilroy. Mr. Chairman, I guess for me it is a little more difficult to separate the issues and say what is the overall——

Senator Exon. Well, let me rephrase the question. Give me your figure on a one to ten scale with regard to its effect on labor; and secondly, one to ten on its impact overall as intended by the Staggers Act.

Mr. Kilroy. I suspect as far as the employees and labor is concerned, it is going to be one, maybe at the most a two. And the reason I say that, Senator, is that since Staggers, since 1980, there has been a 40 percent reduction in the number of employees in the railroad industry.

Now, that amounts to over 200,000, reducing the forces from above 500,000 to around 300,000 today.

Senator Exon. What would it have been, Mr. Kilroy, had we not had Staggers? It would not have gone up; it would have gone down, Staggers or no.

Mr. Kilroy. Well, that is the point where I could not answer, the other part of the question, as to what that has done with respect to. I know there has been statement and testimony that if it had not been for that situation it would be worse, but that is something that it is a little hard for us to understand when we lived with regulation for all of those years.

While employment dropped, it did not drop drastically. And the way we see it, not only has there been the loss of employees, but there has been probably the loss of some 20,000 miles of track, lost forever. It will never be regained.

Senator Exon. You would agree with my earlier statement that it is my belief that, had the ICC done the job that they were supposed to as envisioned when the Staggers Act passed, that we probably would not be holding this hearing today? Do you agree with that?

Mr. Kilroy. Yes, sir, I do, very much so.

Senator Exon. The ICC has exempted line sales to short line and regional railroads from labor protection requirements from time to time, as they are permitted to do under Staggers. It is my understanding that a substantial number of the short lines or regional railroads that have sprung up as a result of Staggers, that they have employed people, of course, and that in the large majority of those cases railroad unions have been formed. Is that accurate?

Mr. Kilroy. Well, I do not know what the numbers are, Mr. Chairman. I do not think we have had an adequate avenue to find out just how many people are working on those railroads.

But for the most part, certain railroads we have been successful in negotiating agreements with the new entrepreneur, and they are represented by the unions, and the contracts may be somewhat less in wages or benefits, not terribly much but somewhat less than they enjoyed on the parent road.

But of course—and there is also, as we stated, the obvious effect that in many cases we question whether there is an entrepreneur at all or whether that is a subterfuge to get around the law, because as you know the law says if it is another railroad that buys it then the employees are protected. If it is a straight abandonment, then the employees are protected.

But in the Staggers Act, I do not think it ever changed that. The law simply permitted the ICC to make exemptions. And apparently, I think as best we can determine, ever since Staggers or subsequently thereto, they have exempted all of those situations that they never exempted before.

So it was really a change in the thinking and the application of the ICC to the Act, rather than a change in the Act itself, that left these people without protection.

Senator EXON. Mr. Gaskins in his testimony indicated that the railroads are the only business in the United States where by Federal statute they are required to pay labor protection to their employees when they sell, merge, or abandon properties. This may include up to six years of wages and benefits for job loss or being bumped into a lower paying position.

Would you care to comment on this statement generally and as it relates to the sales to the short lines or regional railroads?

Mr. KILROY. Well, protection in the railroad industry goes back to 1920. The railroad industry certainly has been unique. At one time it was the only form of at least transportation other than horseback and walking that we had. So protection in the railroad industry is not something that just came up overnight.

And it came up by law mostly, but in many cases by agreement between the employees and management in connection with merger situations and consolidations and coordinations. So it is not something that just got shoved on the industry totally.

There was in many cases total agreement on how that applied. But with respect to the short line sales, this is a method that the parent carrier has of avoiding its labor cost and its protection to the employees involved by rulings of the ICC. And that is what we think ought to be changed, and that is what we are asking your committee to look into and change, because it is unfair.

It is totally unreasonable and unjust to make the employees pay the burden for going into a short line or regional sales operation. They in effect, Mr. Chairman, are subsidizing the entrepreneur, if he be such. He borrows the money to buy the short line. He then reduces his labor costs to help service the debt.

The best that some of the employees can hope is to retain a job. And not all of those, of course, would keep a job, and none of them would be protected.

So we think that that is not what was intended by Staggers and that that should be changed.

Senator EXON. One last question and then I will turn it over to Senator Rockefeller, because I unfortunately, long before I scheduled this hearing, I committed myself to a luncheon today.

It seems to me that one of the biggest potential areas of concern for the railroads and the railroad workers lies in the area of retirement benefits, where, according to the figures that I have, we have now three retirees for every one active railway worker. And this poses in my opinion the potential of increasing financial burdens on both the industry and the workers.

I know all are concerned. Do you have any views on proposals to alleviate this situation? And what are we going to do about it? Sooner or later we are going to have to address this better than we have in the past, because this is a sleeping dog that is going to start barking very soon, I suggest.

Mr. KILROY. Yes, Mr. Chairman. Of course, there is a long history, as you know, behind all of the problems there. Let me just take—instead of going back to Adam and Eve, let us just go back to 1983.

Senator EXON. There were not even railroads in Adam and Eve.

Mr. KILROY. Well, I thought there was.

Senator EXON. There was a union contract in effect, but there were not any railroads.

Mr. KILROY. That is where labor started.

The problem was essentially resolved in 1983, and what has brought about the problem is the very thing I mentioned in my testimony and in some questions, that the industry has reduced the number of employees by 40 percent.

Now, the ratio of retirees to employees working is correct. It is getting worse. And one statement made by one of the CEO's from the railroad this morning was that they wanted to be able to buy out more people to save the rail retirement some money. I do not quite understand that, because those people that are bought out, then there is no more tax. They are taken out of the system, and still many of them would be entitled to a pension at some future date if they were not entitled at the time.

And so the retirement rolls were swelled by this reduction of employees over the past six or seven years, in many cases by buyouts, by virtue of the action of protection agreements, in many cases where the employee had an option to either move with his job or take his separation pay and retire. And if he was close to retirement age, he would retire.

So you have the rolls swelled. Now, that does little good, I guess, except to say that this is a dilemma that we now have and what brought it about.

But it is the industry that has caused the whole problem and not the employees. There are a number—and we do not know the numbers of thousands and thousands of employees who are not covered by the Act because they have contracted out various work to outside contractors who are not covered by the Railroad Retirement Act.

This again all contributes to the overall problem. So we think that, number one, we have agreed to sit down with management in the next months as quickly as we can to address this overall problem of railroad retirement and to see what the proper solutions are.

Of course, we are insisting that the industry pay for the problem that they themselves caused. And Senator, I might add that as long as we have a base on which revenue is paid in on employee numbers—and you heard the testimony of the gentlemen just before us; they are going to reduce this industry another 25 percent or more in the next few years.

As long as the revenue base is based on the number of employees, then the problem is just going to continually get worse. Some other factor should be used, like revenue, ton mile tax, or other criteria. Productivity has increased by some 39 percent in the industry over this period of time, of course, which incidentally is almost the same percentage as the reduction of the number of employees.

So they have gained a lot in productivity, and something more should be done with respect to how you establish the base so that you do not have to keep coming back to Congress with problem after problem.

We think that the least solution and the worst solution is, as some have proposed, simply doing away with it and simply fold the men totally into social security—they are already covered by social security anyway on tier one—and simply do away with it and somehow forget about their obligations.

Amtrak is now proposing to remove 25,000 people from the act through some magic. I am unable to explain how they are going to provide the same benefits, but for less money, but that is what they say they can do. So we are going to take a hard look at it.

Hopefully, we can come back to Congress with some suggested solutions as to how the problem could be resolved.

Senator EXON. Thank you, Mr. Kilroy.

Senator Rockefeller, I am going to turn it over to you to chair the hearing.

Senator ROCKEFELLER (presiding). I have only one brief question, Mr. Kilroy, and that is, do you oppose the Consumer Rail Equity Act?

Mr. KILROY. Senator, the arguments between the group supporting the re-regulation in that area with rates and the industry on the other hand, which says that if those rates are damaged in any way, then the employment situation in the railroad industry is even going to be worse, leaves us in a tough spot.

We have taken no position with respect to that part of the Staggers.

Senator ROCKEFELLER. In any event, by not having taken a position you do not therefore oppose the Act?

Mr. KILROY. That is correct.

Senator ROCKEFELLER. Thank you very much, Mr. Kilroy. That is all the questions that I have.

Mr. KILROY. Thank you very much.

Senator ROCKEFELLER. Mr. Snyder, gentlemen, we are very grateful to you.

The following panel—and we will go on this panel until about 12:25, and then we will have a 25 minute recess. But then we will come back at about 10 minutes of 1:00 and we will continue until we are completely finished the entire hearing.

The next panel is coal and utility shippers and others: Mr. Bob Bergland, Executive Vice President, National Rural Electric Cooperative Association; John Paul, Director of Government Affairs, AMAX, Incorporated, on behalf of the National Coal Association and the American Mining Congress; Mr. William Skewes, who is the President of Ridgeland Company, Bluefield, Virginia; and Mr. James Scahill, Executive Vice President, Pennsylvania Coal Mining Association.

I am delighted that you are all here. Mr. Bergland, perhaps you would begin.

STATEMENTS OF BOB BERGLAND, EXECUTIVE VICE PRESIDENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION; JOHN H. PAUL, DIRECTOR OF GOVERNMENTAL AFFAIRS, AMAX, INC., ON BEHALF OF THE NATIONAL COAL ASSOCIATION AND THE AMERICAN MINING CONGRESS; WILLIAM SKEWES, SR., PRESIDENT, RIDGELAND COMPANY; AND JAMES SCAHILL, EXECUTIVE VICE PRESIDENT, PENNSYLVANIA COAL MINING ASSOCIATION

Mr. BERGLAND. Thank you very much, Mr. Chairman, members of the Subcommittee.

My name is Bob Bergland and I am the executive vice president and general manager of the association of the nation's 1,000 consumer electric cooperatives, serving about ten million families in 46 states.

Most of our electricity comes from power plants fired by coal. Our systems are all rural. Coal has to be hauled in most instances a long ways. It is not uncommon to have a power plant in one state and a coal mine in another and one railroad in between. We are by definition a captive shipper.

Mr. Chairman, I am also the convener of a coalition of interest groups that are supporting the legislation proposed by several members to deal with the issue of the captive shippers. But I am here today as the national representative of the electric cooperatives.

Mr. Chairman, we have no quarrel with the Staggers Act. I was in the government when it passed. It made good public policy sense at the time and still does.

Our quarrel is with the Interstate Commerce Commission and its inability, for whatever reason, to deal with the problem of the captive shipper. The problems are not commonplace throughout the United States. It is a localized matter. But where it exists, it is intense.

The electric business is very competitive. We compete with natural gas as a heat stock in space heating. We compete with other energy forms, some new technologies that are on the horizon. And so ours is a very tough, competitive business.

We therefore cannot automatically in every instance pass on costs to consumers, because they do have alternatives. Such is the nature of the competitive marketplace. We therefore have a specific problem that is localized, and we are asking the Congress for some help to deal with this issue at the ICC.

Mr. Chairman, I have a rather long, detailed statement that I would like to submit for the record and just briefly summarize.

The example which I am offering today as evidence in our case involves a cooperative in Arizona. Arizona Electric Power Cooperative has two 175 megawatt coal-fired power plants at a place called Cochise. It is near no railroad, no waterway or no major truck highway. It is fueled by coal out of New Mexico and the powerplant is served by one railroad.

The cooperative started to run into rate problems about eleven years ago and ten years ago filed a complaint with the ICC. The Staggers Act was passed and during the consideration of the Staggers Act the case at Arizona Electric was an instance offered as a reason for taking care of the so-called captive shippers problem, because here is a classic captive.

The Congress granted certain authorities to the ICC to deal with problems like this on a case by case basis, which was the intelligent way to handle the matter, and the case has been pending there ever since. Ten years has gone by and no relief has been granted.

The cooperative and its members have spent over a million dollars in legal fees presenting their claims and contentions before the ICC and nothing has happened. It just goes on and on, and therein lies our problem, Mr. Chairman.

We urge the passage of the bill S. 676 because this would grant the needed authorities we believe necessary to do what Congress intended when the Staggers Act was passed. We are not calling for repeal of the Act. We are not asking for re-regulation of the industry. We are simply asking for certain streamlining processes at the ICC so the intention of Congress can be fully implemented.

And I thank you very much, Mr. Chairman.

[The statement follows:]

Statement
of
Bob Bergland
Executive Vice President
National Rural Electric Cooperative Association

Mr. Chairman, my name is Bob Bergland. I am Executive Vice President of the National Rural Electric Cooperative Association (NRECA). NRECA is the national service organization of more than 1,000 consumer-owned, not-for-profit electric systems serving approximately 25 million consumers in the more sparsely populated areas of 46 states. I also serve as a convener of the Coalition for Rail Fairness and Competition. The Coalition represents diverse constituencies including consumer, agricultural, manufacturing, electric utility and coal producer interests.

While diverse in nature, each of the members of the Coalition shares a common concern about the Interstate Commerce Commission's (ICC) failure to implement properly the provisions of the Staggers Rail Act relating to captive shippers and consumers and the enhancement of rail-to-rail competition. We are not here today to criticize the principles of the Staggers Act. We are here today to criticize the ICC's implementation of the shipper protections of that Act and to ask the Committee to correct the ICC's poor implementation through legislation.

In 1980, enactment of the Staggers Rail Act substantially deregulated the rail industry. Deregulation was necessary because heavy government regulation and increasing truck competition had put some of the nation's railroads into a steep economic decline. The Rock Island and Milwaukee railroads were bankrupt and Congress and the rail industry knew that something had to be done to save portions of our nation's rail system.

Free market competition replaced government regulation as the new key to reasonable rail rates. However, Congress knew that where adequate competition did not exist, it was government's role to protect those shippers who did not have the protections offered through a competitive marketplace. The Interstate Commerce Commission was given the responsibility to ensure that rail rates to "captive shippers" -- those shippers with no effective transportation alternative -- were reasonable.

Shippers of bulk commodities like coal, grain, chemicals and some manufactured goods have few transportation alternatives. Except where utilities have mine-mouth generating plants or a very short hauling distance that can be served efficiently by trucks or by barge, a coal burning power plant must rely on railroads.

As coal-burning utilities, rural electric cooperatives are often captive shippers with little marketplace leverage to ensure fair and reasonable coal rail hauling rates. As electric systems serving farmers and ranchers, the rural electric cooperatives not only sympathize with, but share many of the same problems that bulk agricultural commodity shippers have experienced with the railroads. NRECA's members and their consumer owners have been adversely affected by unreasonably high coal transportation costs.

Transportation costs are, of course, directly passed through in the form of higher electric rates, and rural electric cooperatives already pay rates that are about 15% higher than that of competing utilities on a nationwide basis. For many rural electric cooperatives, coal transportation costs rank second only to interest among their expense items.

Because of the significance of rail transportation costs, the membership of NRECA at its 45th Annual meeting, held in February and attended by over 12,000 people, adopted the following resolution:

Rail Transportation Tariffs

> The Congress has enacted the Staggers Railroad Act which allegedly includes protection for captive shippers such as coal-burning electric utilities and grain producers. The Interstate Commerce Commission (ICC) has adopted the theory that railroads should be free to establish tariffs in excess of fully allocated costs for captive shippers as a means of compensating railroads for the movement of other commodities, and has failed to afford protection to captive shippers where a single carrier monopolizes shipments through control of sole facilities. As a result of this shift from the traditional ratemaking criteria, based upon actual cost of service, and in the ICC's failure to protect captive shippers, the electric consumers are being required to pay through electric rates for unjustifiable increases in the cost of transportation. These increases can cause present rail rates to double within five years.
>
> Our efforts to work with the appropriate coal transportation organizations, Congress and the ICC to reverse the Commission's punitive and unreasonable ratemaking philosophy have so far proved largely unsuccessful. We continue to believe that rates charged for the movement of coal should allow a reasonable rate of return to the railroads, based upon actual cost of service, but should not be allowed to become a means of subsidization of other railroad traffic.
>
> We encourage the ICC to recognize the captive nature of utility coal movements and to protect coal users against railroads.
>
> We urge Congress to recognize the serious nature of this problem and, further, we vigorously support legislative efforts to provide relief for shippers in a rail monopoly situation.

Perhaps the following example best illustrates why NRECA and its consumer-members are so concerned about the ICC's current implementation of the Staggers Rail Act. The Arizona Electric Power Cooperative, Inc. (AEPCO) is a not-for-profit rural electric generation and transmission cooperative that serves the non-urban areas of Arizona. AEPCO has long been seeking the redress of financial burdens imposed upon it and its consumers as a result of its status as a coal-burning utility captive to railroad coal carriers. While AEPCO's problems began prior to the Staggers Act, AEPCO has not yet been successful in seeking redress through the mechanism Congress placed in the Staggers Act for complaints that existed when Staggers was enacted.

Beginning in the early 1970's, following the OPEC oil embargo, AEPCO undertook an ambitious conversion program, including the construction of two 175 Mw coal-fired units at Cochise, Arizona. Every ton of coal upon which AEPCO depends for its base load power generation has been and must be delivered by the Southern Pacific Railroad. The generating station is not situated in even remote proximity to competing rail lines. There are no inland waterways or coal slurry pipelines that are accessible. Given the quantities and distance involved, the trucking of coal is not practicable.

In 1973, AEPCO received a rail rate quotation of $5.80 per ton from the Southern Pacific and the Santa Fe Railway, the carrier that served the coal source. A year later, despite the fact that tonnage had increased dramatically, the railroads raised their quoted rate to $7.04 per ton. The General Manager of AEPCO testified to this Subcommittee last Congress that after two years of unproductive negotiation, AEPCO filed a complaint with the ICC in 1977, seeking prescription of a rate of $4.07 per ton, which AEPCO felt was a reasonable maximum based upon prevailing rates for comparable movements. The railroads countered with a demand for an even higher rate of $8.64 -- over twice AEPCO's estimated cost of service -- which the Commission quickly approved. Rates then continued to rise through "ex parte" general increases approved by the Commission until, by April 1980, they had reached $12.30 per ton.

In May 1980, AEPCO filed a second complaint challenging the $12.30 rate. An administrative law judge (ALJ) found the rate unlawful to the extent it exceeded $10.88 per ton, and the carriers were ordered to reduce their rates and pay reparations. In 1982, however, the full Commission reversed this decision and vacated the ALJ'S order. While the Commission later confessed error and reinstated AEPCO's complaint, after it was appealed by AEPCO, the Commission never reinstated the ALJ's decision. Since that time, AEPCO has been back before the ICC, pleading its case for rate relief and all the while paying the higher rates under challenge. Today, some seven years after the filing of its complaint and almost six years after the ALJ's initial decision in AEPCO's favor, AEPCO still awaits final action by the ICC.

This ordeal has not been lost on the U.S. Court of Appeals for the Ninth Circuit. On May 8, 1987, the Ninth Circuit issued a ruling on one of the case's sub-issues (Arizona Electric Power Cooperative, Inc., v. United States of America and Interstate Commerce Commission (No. 86-7233). The opinion in this case, written by Judge O'Scannlain, eloquently summarizes the problems captive shippers are experiencing before the ICC.

> Perhaps inspired by Jarndyce v. Jarndyce, the fabled interminable litigation of Dickens' Bleak House, the Interstate Commerce Commission has been presiding over this continuing saga for the last ten years, now in its sixth epoch.
>
> Piercing the misty veil of regulatory sophistry surrounding this proceeding, we see that the Commission had a simple task: to determine the reasonableness of the rate intervenor-respondents charged petitioners for hauling coal in unit trains between 1977 and 1982... Because we find that petitioner has suffered the arcane rigors of the regulatory process long enough, we vacate, remand, and retain jurisdiction to assure that our mandate is promptly implemented.

So, after 10 years of ICC proceedings and litigation on which AEPCO has spent well over $1 million, the ICC has yet to issue a decision on the reasonableness of the captive rail rates challenged by AEPCO.

When placed alongside charges on other Western unit train movements, the rate contested by AEPCO is over 1/3 higher than most rates on similar movements, and almost double others. Moreover, when one considers the rate AEPCO likely would be paying if it had access to effective, competitive transportation alternatives, the overcharges permitted by the ICC's policies take on truly incredible proportions. Rates recently negotiated between coal shippers and carriers in a competitive atmosphere have come in at between 12 and 14 mills per ton-mile. We have become aware of these competitive rates as some of the municipal utility rates have become public knowledge through their competitive bidding process and through some cases at the ICC from which we can derive the rates. The most recent rates under challenge by AEPCO -- $16 per ton -- are approximately 30 mills. At 14 mills, the AEPCO movements would produce a rate of $7.07 per ton, less than half the level under challenge. This means that a full $8.93 per ton -- upwards of $5.3 million per year -- is the premium AEPCO must pay because of its captivity. Every dollar of this is paid by AEPCO's consumer-owner ratepayer. We are at a complete loss as to how the Commission can justify such pricing as consistent with the balance Congress attempted to strike between railroad revenue needs and reasonable rates for captive shippers in the Staggers Rail Act.

At a recent Senate Judiciary subcommittee hearing, ICC Chairman Heather Gradison promised Senator Dennis DeConcini that a decision on the AEPCO case would be announced before Labor Day. We heard similar promises from the ICC throughout the 99th Congress. We hope that the Commission will do as the Chairman promised, but we are none-the-less concerned about a system that results in the kind of problems that AEPCO has faced.

Given the importance of rail transportation for our members, NRECA has been active for many years in transportation issues. We were, of course, very involved in the legislative package which was developed in 1980 entitled "The Staggers Rail Act of 1980." This Act has substantially deregulated the rail industry, even though the package was considered to be a compromise that would balance the revenue fees of the railroads with the need for reasonable captive shipper rates. Unfortunately, the interpretation of that Act by the Interstate Commerce Commission (ICC) through its numerous rulemakings has resulted in upsetting the careful balancing of interests originally intended by Congress. While the ICC has pursued the goal of maximizing railroad revenues with a zeal that every profit-making business would envy, it has virtually ignored those provisions, such as the Long-Cannon provisions, which Congress built into the Staggers Act in order to balance the interest of shippers and carriers.

Mr. Chairman, we have been very disappointed in the ICC's implementation of the captive shipper protections of the Staggers Act. We, too, have noticed that the Commission only seems to act to protect shippers when Congress applies significant pressure on the Commission. In fact the trend lately has been a decision for captive shippers the day before the Chairman of the ICC must appear before the Committee. However, the effectiveness of the captive shipper rate reasonableness process at the ICC -- not the marketplace -- defines the environment in which we must negotiate rail rates when we are captive: does the captive shipper have a reasonable chance of victory, such that the railroad will negotiate with the captive shipper? So even when Congress is not actively focusing on this issue, it is important that the Commission be seen to be vigorously enforcing the captive shipper protections of the Act.

For a shipper without alternatives the rate reasonableness process at the ICC is long, complex and expensive. First, the railroad establishes its rate without any ICC oversight. (I do not say "negotiate" because a captive shipper has little bargaining power.) Second, the captive shipper must hire a consultant or have the in-house capability to determine if the rate in question generates a revenue to variable cost ratio of the least 180 percent. If so, the captive shipper may file a complaint at the ICC. The ICC will have jurisdiction to determine the reasonableness of the rate if the captive shipper proves that:

(1) His rate generates a revenue to variable cost ratio of at least 180% and

(2) The shipper is subject to "market dominance".

In the market dominance determination, the shipper must show that he had no inter- or intramodal transportation alternative, but the railroad may rebut this showing by proving that the shipper has a product alternative (such as another form of fuel for use in an electric generating plant, or even the ability to purchase electric power from a power grid) or a geographic alternative (such as coal from another area of the country or even coal imports from abroad).

Once the captive shipper has proven that he's indeed a "captive shipper," the ICC has jurisdiction to determine the reasonableness of his rate, the captive shipper then also has the burden of proving that his rate is unreasonable. The Coal Rate Guidelines provide that the Commission can grant some type of unspecified rate relief if the railroad in question is shown to be revenue adequate by either the Commission or the captive shipper; the shipper can get rate relief from a revenue inadequate railroad if the shipper can prove that the railroad is mismanaged and the entire revenue shortfall of the railroad is attributable to the mismanagement; and the shipper can get rate relief if he can prove that his rate exceeds "stand alone cost" - the cost of a group of shippers providing their own hypothetical competing transportation system. Now, in light of the recent McCarty Farms case, there may be another system for small coal and other captive shippers -- a "rate cap" based upon the average captive shipper rate paid by the commodity in question. While the idea of a formula is appealing, we are not sure if this is the right formula. More importantly, we wonder how "small coal" will be defined and we wonder if all captive shippers shouldn't have the benefit of a predictable formula. Our concern here is particularly great because the ICC, in the McCarty Farms case, criticized its own "stand alone cost" test as being "extremely complex," "onerous," and "entailing substantial expenditures, in terms of time and money." Throughout this entire process, the captive shipper pays the rate in question.

During the same time period when there has been a deterioration in regulatory protection for captive shippers, there has also been a dramatic increase in the concentration of rail market power. Mergers between railroads have further reduced what little competition was previously available, e.g., the creation of CSX and Norfolk Southern, the Union Pacific consolidation, and rail carrier acquisitions of major intermodal competitors, such as CSX's purchases of American Commercial Lines and Sealand Corporation and Norfolk Southern's purchase of North American Van Lines. Ironically, a greater need for meaningful protections against railroad market power has arisen precisely at a time when the ICC has effectively been dismantling those same protections.

Mr. Chairman, the time has come for the Congress to act to correct the errors and omissions of the ICC in its implementation of the Staggers Rail Act. All previous efforts by Congress to encourage the Commission to reform itself have failed. The members of NRECA and the Coalition for Rail Fairness and Competition urge you and your committee to consider and approve the Consumer Rail Equity Act, S. 676.

The Consumer Rail Equity Act does not change the fundamental provisions of the Staggers Rail Act, nor does it reregulate the railroads or return them to the pre-1980 regulatory system. Rather, the Consumer Rail Equity Act attempts to assure that the Staggers Rail Act is implemented in a fair and sensible manner -- just as Congress intended in 1980.

Under the Consumer Rail Equity Act, the railroads would continue to set rates without Commission oversight, the captive shipper would continue to bear the burden of proving that the Commission has jurisdiction to determine the reasonableness of his rate, and the captive shipper would continue to pay the disputed rate during the pendency of the ICC proceeding, unless the Commission determines otherwise under existing Staggers Act provisions. However, the present "revenue adequacy" test would be replaced with the type of test applied by the state public service commissions; the "market dominance" determination would no longer consider product or geographic competition. (It is hard to conceive of a captive shipper who would enter the ICC process if he had product or geographic alternatives; besides the question is "Is this rate reasonable?" Not "Is something else available?") and the burden of proving rate reasonableness would shift from the captive shipper to the railroad. When determining the reasonableness of a rate, the Commission could continue to use all of its present tests, but would also be required to consider the difference between the rate the railroad is charging and the actual cost of service. Finally, during a rate reasonableness case the Commission would be forced to make affirmative findings on the Long/Cannon factors, which are part of present law. These factors are expressly intended to prevent railroads from charging captive shipper rates that reflect railroad pricing or operating inefficiencies.

The balanced approach to railroad and shipper relations, particularly in the rate area, which Congress built into the law in 1980 has been abrogated by the ICC to the serious detriment of captive shippers and their customers. Congress must now step in and restore the equilibrium -- there is no alternative.

On behalf of NRECA, I strongly urge Congressional consideration and enactment of S. 676, the Consumer Rail Equity Act, to reform the Commission's misguided approach to regulation under the Interstate Commerce Act. Mr. Chairman, let me commend you for holding these hearings on the implementation of the Staggers Rail Act. I appreciate the opportunity to present the views of NRECA and urge the Subcommittee to favorably consider S. 676.

Senator ROCKEFELLER. Thank you very much, Mr. Bergland.

Mr. Paul.

Mr. PAUL. Thank you very much, Mr. Chairman.

I am John Paul. I am Director of Governmental Affairs for AMAX, and I am appearing here today on behalf of both the National Coal Association and the American Mining Congress. These associations, as I am sure you know, represent all or certainly most of the major coal producers in the United States.

I have submitted a very detailed statement going into great lengths on our problems, many of which have been addressed by the previous speaker, and I would like to have that made a part of the record.

Senator ROCKEFELLER. They will all be submitted.

Mr. PAUL. In the interest of time, we have a very brief oral statement that we would like to make.

Preserving an efficient, competitive, healthy railroad network is important to the coal industry. Rail carriers transport two out of every three tons of coal shipped to utility and industrial plants and to the inland and coastal ports.

However, we have a critical problem in regard to railroad transportation because a coal shipper, producer, consumer, or exporter is often captive to a specific rail carrier for particular movements and, quite frankly, the Interstate Commerce Commission has not been providing the protection from unreasonable coal rates.

The Commission has failed to implement the Staggers Act in a manner that ensures captive shipper protection called for in the law. Our aim is not to unload undue criticism on the railroads for trying to maximize revenues. Rather, we are attempting to overcome the past insensitivity of the Commission to the fate of the captive shippers by supporting corrective legislation in the form of the Consumer Rail Equity Act now before this committee.

We can easily document our difficulty with the Commission by looking at a few facts about the situation faced by coal shippers in the period of 1980 to 1985. I have asked Joe Lema, the Vice President of Transportation for the National Coal Association, to assist me with a chart that we have here which I think will demonstrate our position.

Using data obtained from the U.S. Department of Energy and from the Association of American Railroads, we show on the chart year to year changes from 1980 to 1985 in four major areas: first, railroad productivity; secondly, railroad coal rates per ton; thirdly, the coal mining productivity; and mine prices per ton of coal.

Rates and prices have been adjusted using the gross national product deflator to put them in real terms. And I think the evidence is clear.

While mine prices of coal have dropped 21 percent on average, because of 43 percent more productivity at the mines in terms of tonnage per person per day, railroad coal rates on the average have remained essentially unchanged, notwithstanding a 39 percent gain in railroad productivity expressed in revenue ton miles per employee hour paid.

Coal mine operators have been working hard to improve productivity using techniques like long wall mining equipment in deep mines, computer controlled high capacity drag lines, and a lot of other activities to reduce our costs. So the coal prices are lower and the coal becomes more competitive in domestic and export markets.

Railroads likewise find unit trains to be highly efficient components of their traffic. Unit trains make railroads vastly more productive.

But the benefits have not been shared with the shippers. We believe this is unfair and seriously harms the competitiveness of American coal. We do know that the railroads can reduce coal rates and still find coal traffic to be quite attractive.

I think the perfect example of that was—in fact, it was discussed at length by the previous panel of CEO's—when you look at what happened in the Powder River Basin, which was a pure, true, perfect example of captive shippers. When a second railroad came in, the rail rates dropped 25 percent, and I am sure that the railroad that came in is still making a fine profit.

Therefore, Mr. Chairman, I think our position is quite clear, and I think this chart dramatically expresses what has happened. And I thought it was quite humorous to listen to the previous panel talk about the deplorable situation of the railroads and I guess suggest that they need some help from this committee.

Well, I would only suggest that I think this chart clearly shows that, if in fact there is a problem, we are the ones who are really suffering. If you look at the bottom line on that chart, which is headed downward, and there are no signs on the horizon that it is going to go up, and you look at the middle line, which I believe goes to 99, which is a one percent drop in the rates, you can see that this partnership and this cooperation that I hear them talk about for an hour this morning does not seem to be demonstrated on that chart.

Thank you, Mr. Chairman.

[The statement and questions and answers follow:]

STATEMENT OF JOHN H. PAUL ON BEHALF OF NATIONAL COAL ASSOCIATION AND THE AMERICAN MINING CONGRESS

Mr. Chairman, my name is John H. Paul. I am the director of governmental affairs of AMAX, Incorporated. I am appearing before you today on the National Coal Association (NCA) and the American Mining Congress (AMC). These two associations represent most, if not all, of the major coal producers in the United States.

I am pleased to announce that effective April 1, 1987, NCA and the Mining and Reclamation Council of America (MARC) were merged into one organization which now represents producers of about seven out of every ten tons of coal mined in the U.S. NCA and AMC have a strong interest in securing efficient, competitive and reasonably priced railroad services required for transporting coal and utility and industrial plants and to inland and coastal ports. For that reason, we commend the subcommittee for conducting this hearing. We truly appreciate the opportunity to testify here today.

We believe the Interstate Commerce Commission is not implementing the Stagers Rail Act of 1980 in the manner prescribed in the law. The Commission has failed to protect captive shippers from unreasonable rates where a single rail carrier represents the only effective transportation available for specific movements. Such protestion is called for in the provisions of the Stasggers Rail Act, yet the Commission has not been responsive to such requirements in the law as it administers the regulatory process. That is unconscionable. The Commission has responsibility for implementing all provisions in the law, including those aimed as assuring that rates are reasonable for captive traffic.

The situation encountered by shippers, producers, consumers, and exporters of coal is particularly egregious. Two out of every three tons of coal shipped to utility and industrial plants and to inland and coastal ports are transported by railroad, and coal accounts for about two out of every five tons of traffic carried by railroad.

Much of the coal traffic has no effective alternative to a single rail carrier for essential transportation services, making coal shippers especially vulnerable to abuses in railroad rates. That a rail carrier would attempt to obtain maximum revenues from shippers is not surprising inasmuch as the railroads are businesses operated for profit. However, it is inexcusable for the Commission to allow railroad rates to be set at unreasonable levels in circumstances when the rail carrier holds market dominance over certain traffic. That is what has happened since passage of the Staggers Rail Act in 1980 with regard to many coal movements where there is no effective transportation competition available.

A look at the record since 1980 shows the Commission's failure in regard to railroad coal rates. Coal producers have been working diligently to hold down coal prices in order to be competitive in domestic and world markets. Yet the same is not true with regard to railroad transportation. The railroads claim that they are in effect partners with coal producers in their services areas with respect to a combination of coal supply and transportation. However, it is clear that has been an unequal partnership. In many instances these carriers have improved their productivity much like coal producers. However, the carriers have not worked with the coal shippers to enhance coal's competitiveness. A principal culprit has been the Commission. It has not utilized rational standards for determining rate reasonableness. This has handed the carriers unwarranted bargaining power in negotiating transportation contracts. Because of a fear of these irrational rate standards governing the reasonableness of public tariffs, shippers are forced to accept whatever terms are offered by the carriers in negotiating contracts.

The situation is illustrated by a chart incorporated as Appendix A in the testimony. The chart shows trends in railroad productivity and railroad coal rates compared with coal mining productivity and prices of coal at the mine from 1980 to 1985. Coal statistics were obtained from the U.S. Department of Energy's Energy Information Administration and railroad data were obtained from publications of the Association of American Railroads. Mine prices and railroad coal rates are represented in indexes that were calculated based on real dollars with adjustments made utilizing the Gross National Product Delfator in each case. As the chart shows, coal mining productivity increased 43 percent from 1980 to 1985 and that has resulted in a 21 percent gain has been due to utilization of long-wall mining equipment in deep mines, high capacity drag-lines in surface mining operations, and huge off-road vehicles and high speed conveyor systems for moving coal on-site to automated railroad loading facilities.

Those improvements have resulted in major productivity gains which have lowered the price of coal per ton and aided its competitiveness. However, much of the prospective rise in competitiveness has been lost because similar productivity increases in railroad transportation have not lowered railroad coal rates. As the chart shows, railroad productivity, which was calculated based on revenue ton-miles per employee-hour paid for all railroad traffic, increased 39 percent from 1980 to 1985. That is strikingly similar to the 43 percent improvement in coal mining productivity during the same period, measured in terms of tonnage per person per day. However, at the same time, railroad coal rates per ton stayed about the same in 1985 as in 1980, remembering that both mine prices and railroad coal rates are being compared in real dollars using the GNP deflator for adjustments. Surely a major downward adjustment should have been experienced in railroad coal rates. It is especially noteworthy that the productivity improvement in railroad transportation was for all traffic, not just coal movements. With that in mind, it is very reasonable to expect that greater increases in railroad productivity should be associated with coal traffic inasmuch as coal is transported for the most part in unit trains or trainload volumes exhibiting significant economies of scale in railroad operations. Furthermore, producers and consumers typically furnish highly automated loading and unloading equipment for coal movements, all of which make the movement of coal more efficient than handling non-coal traffic.

A graphic example of how much railroad coal rates can be adjusted downward without injury to the railroads is given by recent experience in shipments of coal from Wyoming's Powder River Basin. Where new rail-to-rail competition emerged in the last two years for such movements, the railroad coal rates dropped about 20 to 25 percent, indicating that previous rates had been set way above competitive, reasonable amounts.

Mr. Chairman, I feel it is important that I dispel an often raised, but nevertheless false, contention that a railroad would not act in a manner that might cause losses in its coal markets, either domestic or foreign. A number of rail carriers have claimed that a railroad would never price its coal transportation service at higher than competitive levels, even on captive shipments, because it would cause the delivered price to increase and could result in a loss of that coal market and concomitant reduction in railroad revenues. However, that notion simply does not comport with reality. In the absence of competition from other carriers, railroads typically base the price of their coal transportation services on what the traffic will bear. They recognize that what might be lost in a particular instance will usually be recovered elsewhere in the carrier's service area. Even if those losses are not recovered elsewhere, it is often more advantageous to continue to charge its remaining coal shippers what the traffic will bear in view of the fact that losses of some coal tonnage lowers the railroad's overall costs. A railroad's profits are enhanced even though its particular share of the market may drop. For example, I would like to cite some findings by the very well qualified and highly respected firm, National Economic Research Associates, Inc. (NERA). In a verified statement dated December 18, 1981 incorporated into comments of the Coal Exporters Association and NCA submitted to the ICC on December 21, 1981 in Ex Parte No. 346 (Sub-No. 7), Railroad Exemption—Export Coal.[1] NERA, at page 3 of its verified statement, stated:

> The ability of the railroads to raise rates can cause their own profits to increase but can also cause reduced coal exports and lower profits (and lower revenues) for coal mine operators.

Upon examination of economic losses caused by the proposed exemption of railroad movements of export coal from regulation, also at page 3 of the same verified statement, NERA stated:

> The following is an example of predicted effects:
>
> 1. Deregulated rail rates for export coal would average 57 percent higher than if they remain regulated.
>
> 2. At the higher freight rates, about 450 million fewer tons of steam and metallurgical coal would be exported between 1983 and 1990, resulting in a loss of domestic shipper revenues of $20.8 billion. The loss in export receipts, including higher rail revenues, would be $21.4 billion, which would impost costly adjustments on the U.S. economy
>
> 3. The higher freight rates for export coal would result in a cumulative reduction in U.S. real income of $4.2 billion over the period 1983–1990. Railroad profits would increase by about $3.0 billion, but this would not be nearly large enough to offset consolidated losses of approximately $7.2 billion to the other sectors of the economy.

The harm done by excessive railroad coal rates is brought home clearly by what has happened to U.S. coal exports in recent years. Railroad coal rates have been cited by representatives of Japan as well as some European governments as a primary reason for losses experienced by U.S. coal suppliers and exporters in the world coal market. A most vivid picture of the influence of railroad coal rates on the ability of the U.S. coal industry to compete in the world coal market can be seen by examining the trends in mine prices and rail rates for export coal during the 1980's.

A particularly gripping example of the problem faced by U.S. coal producers who have taken great strides toward keeping U.S. coal competitive in world coal markets through increasing productivity and lowering costs at the mine, and whose efforts are being thwarted because railroads are raising coal rates, was described recently by Mr. Kai Bograd, deputy managing director of the Danish utility, ELKRAFT. In a presentation at the U.S.-European coal conference held in Rome a few weeks ago, Mr. Bograd examined changes in components of coal's delivered price from 1983 to 1987. A chart presented as Appendix B in my testimony shows the figures stated by the Danish utility executive. To remain competitive, U.S. coal producers since 1983 reduced mine costs by 43 percent, terminal costs were reduced by 40 percent, and we have seen a reduction in ocean freight rates of 29 percent. But, at the same time, Mr. Bograd added, the railroads have increased their export freight rates by 15 percent.

This current experience of the Danish utility executive dramatically underscores the problem caused with respect to the competitiveness of U.S. coal in world coal markets by significant increases being experienced in railroad rates. Such increases in railroad rates for export coal traffic raises the delivered price of U.S. coal in world coal markets, adversely affecting our competitiveness and harming what should be excellent opportunities to enhance our balance of payments in international trade that could be attributable to increased productivity and lower mine prices in regard to coal supply prior to transportation by railroad from the mine. Certainly a major national need exists today with respect to enhancing our balance of payments in international trade; a goal to which U.S. coal can contribute substantially if it is not impaired by excessive railroad freight rates.

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[1] Comments of Coal Exporters Association and National Coal Association before the Interstate Commerce Commission in Ex Parte No. 346 (Sub-No. 7) Railroad Exemption—Export Coal, December 21, 1981; and Verified Statement of National Economic Research Associates, Inc., December 18, 1981.

Another example of this problem is the situation faced by suppliers and exporters of metallurgical coal, a long-standing major share of total U.S. coal exports shipped from the Port of Norfolk, Virginia. Mine prices of the metallurgical coal, due to increased productivity by U.S. coal producers, dropped about 15 percent in the period, 1980 to 1986. However, at the same time, the rates charged by the railroads increased about 14.5 percent. Although the metallurgical coal was valued aboard ship in the port about 11.5 percent less in 1986 than in 1980 as a result of lower mine prices for the coal, its value loaded aboard ship should have been significantly lower yet had it not been frustrated by rising railroad rates over the period. Again, as a result of increases in railroad freight rates, U.S. coal lost a substantial amount of competitiveness in world coal markets. Obviously, that is of high concern.

The Staggers Rail Act, signed into law on October 14, 1980, was the result of a compromise on railroad regulatory reform reached after intense debate during congressional consideration in 1979 and 1980. This legislation struck a balance between the need to improve pricing flexibility of the railroads and the need to protect captive shippers from abuses in rail rates and service. It continued the Interstate Commerce Commission (ICC) as an independent agency of the United States government responsible for administering railroad regulation. The coal industry participated in the regulatory reform process, and because of our reliance on railroad services for essential transportation, supported the reforms embodied in the Staggers Rail Act. It retained in law certain railroad regulatory provisions, and continued the Commission as an independent regulatory body whose purpose was to administer the regulatory process. This was done at a time when the airlines and motor carriers were being deregulated and attempts were underway to treat railroads similarly even though they, unlike other modes of transportation, often possess monopoly power over freight movements.

In addition to providing traditional service under public tariffs, the Staggers Rail Act also allowed rail carriers to negotiate private contracts covering particular movements. It incorporated ways to increase the efficiency of the railroads. It set deadlines for decisions on regulatory activity before the Commission whether those decisions involved a rail carrier versus a shipper or a rail carrier versus another rail carrier. Another critical provision in the Staggers Act authorized the creation of the Railroad Accounting Principles Board (RAPB) to develop principles to govern the determination of accurate costs for particular railroad movements, as required for all regulatory proceedings (for example, the determination of railroad revenue adequacy, rate reasonableness, and rail cost adjustments). Thus there were many good reasons to support the legislation enacted in 1980. It constituted regulatory reform, not total deregulation of the rail industry. Unfortunately, since enactment, the Commission has eroded the captive shipper protections mandated under that law.

The ICC has eroded these protections by adopting regulatory standards which undermine those provisions in the Interstate Commerce Act, as amended by the Staggers Rail Act, which were intended to furnish shipper protection. First, the Commission has used the notion that product and geographic competition may exist to frustrate the ability of a shipper to prevent rate abuses. The Commission has said that if the item transported could have been obtained somewhere else or could have been substituted by a commodity obtained elsewhere, then the shipper is not subject to market dominance and therefore is not entitled to seek relief from rail rates charged for the traffic at issue. That blatantly evades what Congress intended on market dominance. Clearly, market dominance deals with availability of transport options, not product or geographic competition.

Second, the Commission has sought to endorse the railroads in their attempt to exempt railroad movements of export coal from regulation. After lengthy litigation before the Commission, the U.S. Court of Appeals and the U.S. Supreme Court, the coal industry was able to obtain a reversal of the exemption granted by the Commission and return regulatory protection to export coal traffic. However, the predisposition of the Commission to the position of the railroads on the export coal issue leads us to attempt to firmly resolve the matter through legislation.

A third area wherein shipper protections have been eroded by the Commission has been in the calculation of the Rail Cost Adjustment Factor (RCAF). The Commission has failed to include productivity as an element in the determination of the RCAF, which is a quarterly index utilized to raise or lower rail rates automatically. In failing to incorporate a productivity element in the RCAF, the Commission is ignoring the positive strides in rail carrier productivity. Equity dictates that these gains must inure to the benefit of shippers and thus be reflected in the RCAF.

Further, the Commission refuses to recognize the financial health of the railroad industry. It continues to make annual determinations that no class I rail carrier has adequate revenues. Those determinations must certainly be questioned when one considers that some railroads are in a position to pay cash for barge lines, trucking companies, other rail carriers, natural gas producers, commercial real estate, and other enterprises not related to railroad service. The Commission's simplistic look at a rail carrier's return-on-investment as the single criterion upon which to evaluate the carrier's revenue adequacy is the flaw we see in the process.

Finally, the most egregious example of the Commission's refusal to protect captive shippers from monopolistic rate abuses has been its refusal to accept that rates charged in the absence of effective transportation competition must bear a rational relationship to the actual costs incurred by the railroad in providing that service. Certainly, the rail carrier must recover that variable costs which are attributable to the movement as well as a fair allocation of its fixed costs. This would also naturally include a provision for a rate of return that will be sufficient to attract capital for investment in the business. However, to let a rail carrier charge a captive shipper "what the market will bear" is unconscionable. The Commission's refusal to consider the actual cost of providing the service in its determination of rate reasonableness is nothing short of an endorsement of inefficiency. It permits massive cross-subsidization of competitive traffic by the revenues extracted from captive shippers beyond the differential pricing contemplated in the law.

Some may say that the railroads are merely doing what any businessman would do, i.e., maximize revenues. Yet that is surely no excuse for the Commission to endorse monopolistic pricing of railroad services by failing to come to the aid of captive shippers, a fundamental requisite for the Commission's existence.

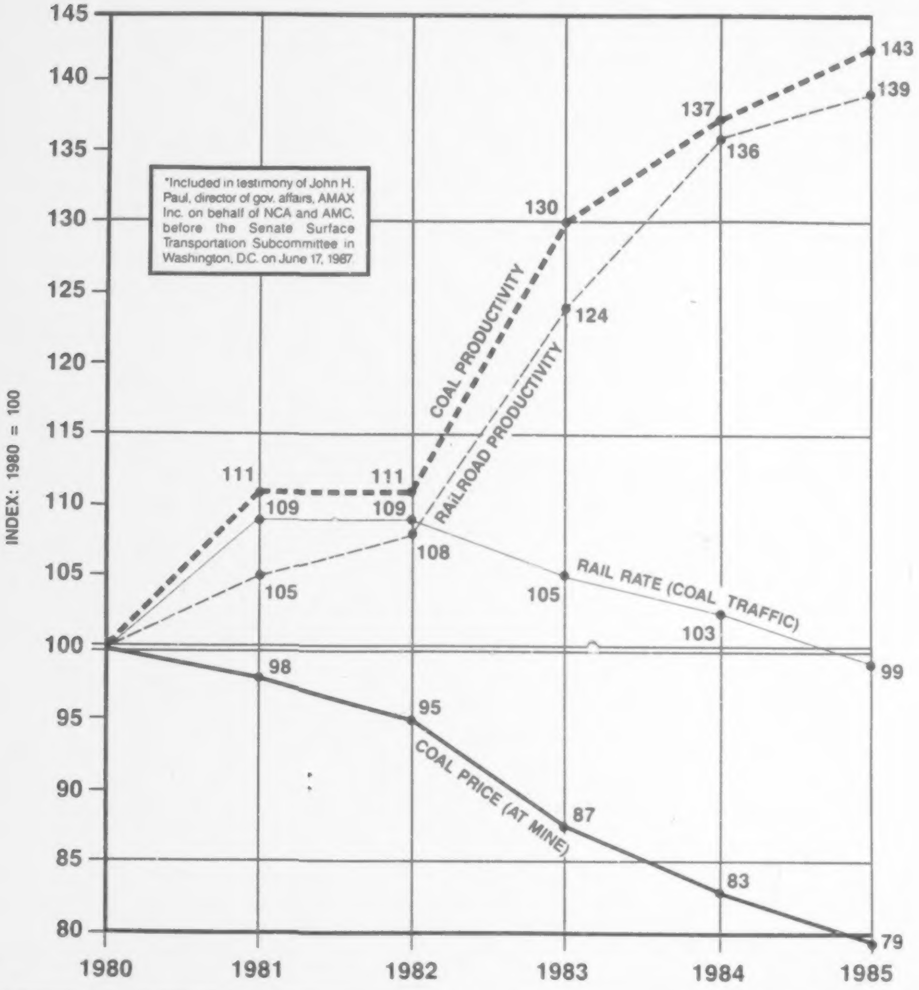
Mr. Chairman and members of the subcommittee, the serious problems created by the Commission in the past six years can be corrected by enactment of the Consumer Rail Equity Act which now lies before this subcommittee. NCA and AMC support the bill wholeheartedly, and respectfully urge an early mark-up of this legislation and favorable consideration before the full House. In doing so, you will be giving the specific directions that are needed by the Commission in order to secure the balanced regulatory process called for in the Staggers Rail Act. The detractors of this legislation will say that it amounts to re-regulation. That is wholly inaccurate. Regulation exists today under the Interstate Commerce Act, as amended by the Staggers Rail Act. The Consumer Rail Equity Act justly provides that the captive shipper protection embodied in the law will be implemented, not disregarded. The opponents of this legislation are comprised of the Commission itself, the railroads, and certain shippers who have the distinct advantage of possessing competitive trans- portation alternatives. Additionally, the U.S. Department of Transportation opposes this legislation. As you well know, the Department of Transportation has demonstrated its lack of concern for captive shippers in its dogged, but unsuccessful, fight to sell Conrail to another major railroad holding company despite the anti-competitive effects that would have resulted.

On the other hand, Mr. Chairman, there are also many supporters of the Consumer Rail Equity Act. These include of course the coal industry, the electric utility industry, consumers, and a broad-based group of shippers of commodities such as chemicals, agricultural products, wood products, and iron and steel. Legislative action represents the only remaining avenue of relief for the problem which these captive shippers face. Problems which face the general public as well, because ultimately it is the public which must bear the burden of excessive rail rates.

Mr. Chairman, that completes my testimony . I will be glad to respond to any questions from the members of the subcommittee. Thank you for allowing me to appear before the subcomittee.

Appendix A

Trends in Railroad Productivity and Coal Rates Compared with Coal Mining Productivity and Mine Prices of Coal in the Period 1980 to 1985*



*Included in testimony of John H. Paul, director of gov. affairs, AMAX Inc. on behalf of NCA and AMC, before the Senate Surface Transportation Subcommittee in Washington, D.C. on June 17, 1987.

NOTES:

1. Numbers are index figures with base year 1980 = 100.
2. Values utilized are averages for mine prices per ton, rail rates per ton, mine output in tons per person per day, and railroad productivity in revenue ton-miles per employee-hour paid. Prices and rates were adjusted using the Gross National Product Deflator.

KEY TO SYMBOLS

━━━━━━ **Coal Price (Mine)**

▬ ▬ ▬ ▬ **Coal Productivity**

────── **Rail Rate (Coal)**

— — — — **Rail Productivity**

SOURCES: U.S. DOE—EIA, and Association of American Railroads

APPENDIX B: INFORMATION ON INCREMENTS OF THE DELIVERED PRICE OF U.S. COAL FROM 1983 TO 1987 AS PRESENTED BY DANISH UTILITY EXECUTIVE, KAI BOGRAD AT THE U.S.- EUROPEAN COAL CONFERENCE

American Coal Shipped from the East Coast

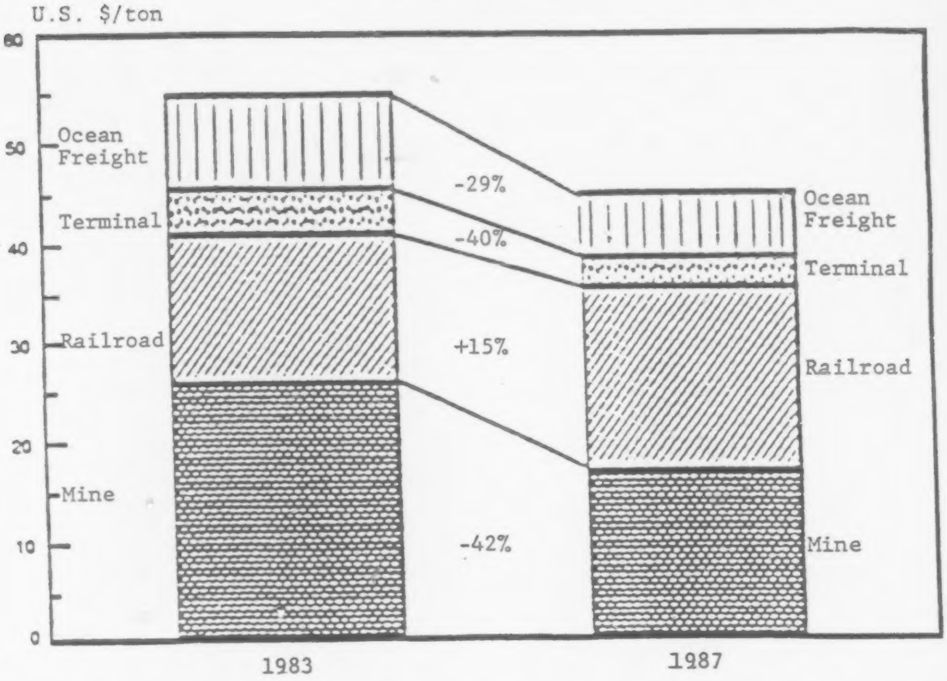


Chart included in testimony of John H. Paul, director of governmental affairs, AMAX Incorporated, on behalf of National Coal Association and the American Mining Congress, before the Senate Surface Transportation Subcommittee in Washington, D.C. on June 17, 1987.

AMAX INC.

Office of
Federal Affairs

July 17, 1987

The Honorable Ernest F. Hollings
Chairman
Committee on Commerce, Science,
and Transportation
United States Senate
Washington, D. C. 20510-6125

Dear Chairman Hollings:

I am writing in response to your July 6, 1987 letter which transmitted a question in regard to my June 17 testimony on behalf of the National Coal Association and the American Mining Congress before the Surface Tranportation Subcommittee, on the implementation of the Staggers Rail Act by the Interstate Commerce Commission.

The question asked by Senator Rockefeller is: "Do you agree that if American railroads carried American coal for free, that American coal would still not be competitive in world markets?"

In response, I would first say that it is clear to me that if American railroads carried American coal for free, a proposition that I am sure is hypothetical and not considered to be a likely circumstance, American coal would have greater competitiveness in world markets inasmuch as railroad transportation represents a major portion of the delivered price of export coal. It should be noted that, although American coal exports have dropped from 110 million tons in 1981 to about 80 million tons yearly at present, the fact that we still are exporting that volume annually shows that we have an appreciable level of competitiveness today, albeit not the level we could secure if railroad coal rates were lowered.

The situation we face today is rather ironical. We have abundant reserves of high quality coal, plenty of mining as well as inland transportation capacity to serve export coal markets, and substantial port terminal coal handling capacity which has been added in the 1980s and is significantly underutilized at present. Thus, American coal is positioned to capture a greater share of the world coal market, and thereby enhance our balance of payments in international trade; however, unreasonably high railroad rates are hampering us from doing so.

We believe that, if railroad coal rates charged export traffic were lowered to reasonable levels, American coal exports would grow. Our customers in Europe and the Far East, as indicated in my testimony, have cited railroad rates as a major factor limiting the attractiveness of American coal. Coal producers have accomplished substantial gains in mining productivity, prices of coal at the mine have dropped in the 1980s, and ocean freight rates also have become lower as a result of competition. Yet the railroads have been increasing their rates, a move that cancels much of the prospective gains in competitiveness that should be realized from lower prices at the mine and lower rates for ocean transportation. To overcome that difficulty, we strongly support the Consumer Rail Equity Act, legislation that will clearly direct the ICC in regard to furnishing captive shipper protection, and substantially benefit American coal exports.

Sincerely,

John Paul

John H. Paul
Director

Senator **Rockefeller**. Thank you very much, Mr. Paul.

Mr. Skewes.

Mr. **Skewes**. Mr. Chairman, my name is Bill Skewes. I am president of the Ridgeland Company, which operates in Gary, in the vicinity of Gary in McDowell County, West Virginia, with offices in Bluefield, West Virginia. I have been involved in the coal mining business in West Virginia all of my life.

My father was chief engineer at Consolidated Coal for 20 some, 30 some years in West Virginia. My grandfather and great-grandfather were both manager of a copper mining business in the region up near Canada probably along Lake Superior. And as those areas dwindled, we became coal miners again, as we have been, I think, about seven or eight generations back in Cornwall, England.

My son Rusty, Bill Junior, is vice president of the Ridgeland Company. And the Ridgeland Company has been in operation since 1896. Our business is producing coal from the Pocahontas coal field in West Virginia, primarily for export.

I am not here to testify against the Staggers Act. It was a good idea and largely seems to be working well. I know that many shippers are pleased with the changes made by the law and are receiving better service and better rates. You should not jeopardize these benefits.

I am not here to testify against the railroads, either, no matter what they may think, although I do not really understand the reasons for some of the things I want to tell you about, and although I am certainly not pleased about them. I do not want to be misunderstood.

Railroads are like any other business which needs to make a profit to stay in business and provide a return for those who invest in it. I am not here because I want to deny any railroad that opportunity or because I think railroads are poorly managed or driven by evil motives.

I am here to tell you that my opportunity to market my coal and make a profit is being frustrated by my inability to obtain a competitive rate for my coal. I do not doubt for a moment that the Norfolk & Western, the only railroad that serves our area, is acting in what it sees as its own best interests.

They have worked with me and I think are sympathetic to what Ridgeland is trying to do. We are finding, though, that no matter how hard we work to improve our efficiency and market our coal—and we have worked very hard, even for this hard business—we are confronted by a rail rate that will not come down and seriously undercuts our ability to compete.

We are losing business and our coal, which is some of the best quality coal in the country, is being left in the ground.

Ridgeland is doing something that is probably a little out of fashion today. As some of you may know, the Pocahontas coal field is the oldest coal field in West Virginia. The first three mines were opened around 1884. There were about three billion tons of Pocahontas No. 3 seam in place in the field—that is in the southern West Virginia area—of which two billion tons have been mined.

Now, of that two billion, one billion actually got to market because you lost some in cleaning it, you lost some and left some in the mine. But of the original reserve, one billion went to market.

The one billion tons that are left, needless to say, are the fringe and the higher cost deposits. You always get the best coal and then you go to the tough conditions. The larger companies have simply given up trying to mine what is left in the fields and closed their mines some time ago. Many knowledgeable people, perhaps including some who work at the Norfolk & Western, will tell you that this is a coal field whose time has come and gone and that no one can make money trying to mine what is left.

The Ridgeland Company is trying to prove them wrong, and I think we can succeed. I am proud of how we have set about trying to develop a market for this coal. Our mines are worked by union members using the latest techniques and many techniques that I personally developed. And we have an excellent safety record, the best in the field.

We have made great strides in productivity and efficiency improvements, and our union has worked closely with us. I have spent all my professional life figuring out how to get the best productivity from problem coal mines. So I have plenty of experience.

Altogether, about 120 people are employed by our mines or contracted to Ridgeland. We also represent probably another 250 people who are in the service industry that go along and help us from the outside, from engineering to other forms of surveying and sampling coal and so forth. You could not ask for harder working or more productive people.

We are the last company trying to work the Pocahontas 3 seam in McDowell County, and I could go down the line of all the majors that had steel mills and steel companies that had mines in that field, and how they have gone down one after another.

Mr. Chairman, this is some of the highest quality coal in the world. It is low volatility coal and virtually smokeless. Up until World War Two, it was highly prized and highly priced, used first as a residential fuel and then as a boiler fuel. When cheap Texas crude oil began flowing through pipelines to fuel the war, the Second World War effort, much of this market was lost.

When steel mills began their large postwar expansion, the field revived as a source of metalurgical coal and it enjoyed another heyday, until the American steel industry began its well-known decline. By then, as I said, most of the coal had been extracted and big coal operators began to leave.

I knew that somewhere someone could use this high quality product, and I knew that there were ways to get it out of the ground at the right price. At home, we tried such things as new washing techniques which we have developed which are more efficient, and they target specific markets, which was never done before, and they do not waste as much coal.

And abroad, we looked for and found markets for these coals. In 1980, we pioneered the first use of low volatility Pocahontas coal for utility purposes by selling the coal to power French cement plants. From 1980 to 1983, we shipped about 300,000 tons a year to France, moving this coal on the Norfolk & Western down to Norfolk, to Lambert's Point. All told, we shipped about 500,000 tons a year since 1983. In other words, our total capacity is about 500,000 to 600,000 tons a year.

And I know this is not a lot of coal compared to what other companies can produce, but this was a good start for this field. We continued to look for ways to improve our efficiency and to find new markets.

Then in 1983, this contract that we had with the French—well, it did not look like much in 1980. By 1983 the cement market began to disintegrate. This business with the French became a real plum and we found that there were people, companies, coal companies, railroads, all interested in taking this business away from me.

I was interviewed by NBC and CBS, who came down to the Pocahontas coal fields. They saw the rust on the rails, they saw people sitting on their front porches who had been trained, Federally, state, had been to schools. Their whole life was going away. They were sitting there with no jobs left.

And they saw my operations and they said, what are you guys doing working? The whole county, McDowell County, has got 75 percent unemployment. What are you doing working?

I said: We have a new way, we found a new way to revive the field. Well, I guess that got around, because when it came time—when the time came to renew that contract, although I was the lowest underground coal bidder in the United States, I did not have a chance in hell of getting that contract renewed, because other railroads and forms of transportation dropped their rates enough to put me out of the contract.

So my ability to target new contracts and to bring some wealth back to southern West Virginia looked like it was going down the drain.

Senator ROCKEFELLER. I am going to have to cut you off here in just a moment. Are you about finished?

Mr. SKEWES. Yes, I am.

Mr. Chairman, I am not exaggerating. When we found out we were going to lose this business, we could not even get the phone calls we needed to talk to the Norfolk & Western. But we, through a personal connection, we finally reached the senior management of the Norfolk Southern. By that time we had lost the business.

In the meantime, we broke into the Turkish met coal contract, and from that time until now we have shipped about 300,000 tons a year to the Turkish steel industry. We now have lost this business to the Australian coal industry. I cannot tell you exactly why, but I can tell you this: We were told that the delivered price of the Australian product was three dollars per ton cheaper, while the ocean freight portion was three dollars per ton higher.

So between the mine mouth price and the rail freight charge to port, the Australian mines have a six dollar advantage.

I can also tell you that since 1980 the mine mouth price of Pocahontas coal has gone from a range of $43 to $48 down to a range of $27 to $30 a ton. During that same period, as far as I know the rail rates have been virtually unchanged. We lost our French business, then our Turkish business, but our rail rate stayed the same. We cut costs at the mine, we cut the price at the mine and my union workers have made major concessions. Other railroads have lowered their rates to take business away from us, but our rate has stayed the same.

Let me tell you that we have had many discussions with Norfolk & Western employees, maybe too many for a company of our size, and I think they are very sympathetic to what we are trying to do. They have told me that we are putting people back to work, that they know we are building markets for them, and that we are contributing to their profits. I don't know why they won't drop their rate for our coal. They may very well have a good reason, but I've never been told what it is.

Should I go to the ICC, Mr. Chairman? Five hundred thousand tons of coal is a lot of coal to me, but whatever profit I can get from it hardly begins to pay for the lawyers and consultants you need to prosecute a case there. To coal producers in West Virginia, the ICC is just a distant pro-railroad bureaucracy. I also think it is worth pointing out that the ICC is the agency that decided to completely deregulate export coal. I don't know what others might think, but all those factors tell me that going to the ICC would be a waste of time and money.

I want to make it very clear that I do not believe in regulation. I am a great believer in competitive markets, and I think the recent history of Ridgeland shows I am not afraid to compete, and I think I know how to compete.

But when I am confronted by the rail freight rates that do not change regardless of what happens in the competitive market, I begin to see the wisdom of having a forum for producers like me to air our complaints. I might not ever use the ICC, in fact, I would do almost anything I could to avoid using it. But when I have no other place to turn, the ICC should be there. I'm getting to the point where I think I and my employees have done all that we can, but there is no way that I would take my case to the ICC today. If you're going to have an ICC, it should work.

That concludes my testimony, Mr. Chairman, and I would be pleased to answer your questions.

Senator ROCKEFELLER. Mr. Scahill.

Mr. SCAHILL. I am Jim Scahill, vice president of the Pennsylvania Coal Mine Association. We are a trade association of 96 coal mining companies of the surface method in Pennsylvania. We also have 125 related supply and services companies in our association.

Our companies represent 85 percent of the surface mine tonnage of Pennsylvania and approximately 46 percent of the total tonnage in the state—in a state, also, that has lost 40 percent of its licensed operators in the last ten years due to everything that could ever happen to the coal industry has happened.

I am here to give PCMA's perspective on the implementation of the Staggers Rail Act of 1980. We testified on the same subject in 1983. Since most of the PCMA operators deal with one particular railroad, that perspective will reflect the regional bias, that of the state of Pennsylvania. And Mr. Paul of AMAX has given the National Coal Association's view on Staggers and its implementation.

I do have a written statement that I would submit for the record.

The downfall of the Penn Central was just another rock in the bag as we went down the river as far as harming and declining the Pennsylvania coal markets in the seventies. And out of the ashes of the Penn Central and the other regional railroads, we got Conrail.

The Staggers Act that was passed in 1980 was hotly and strongly supported by the coal industry, the entire coal industry. And while short of wholesale deregulation, the Act substantially eased the regulatory burden of the rail industry. In fact, no criticism that I can see has been leveled at the Act itself, only implementation by the ICC.

Our operators deal with one railroad, Conrail mainly. Conrail has worked aggressively to market our coal. What we have seen is—and I was accused humorously by Senator Danforth the last time I was here that I am a cheerleader for Conrail. I think that is significant, that our operators have managed to work hand in hand with the railroad that we deal with to market our coal, not just give us a rate and tell us, we can haul your coal, to market our coal for us through many strategies, the West Virginia strategy, Pier 124 revitalization, et cetera.

The cheerleading aspect might help if I say that from 1982 to 1986 Conrail's rates for utility coal decreased by 14 percent. We have seen a real decrease in the rates. PCMA operators have not to my knowledge filed one complaint with the ICC. We do not have any problems with working with railroads that we deal with in that regional, again, bias.

Mr. Chairman, what I would offer is that that implementation—and there are volumes of testimony pro and con on the ICC implementation—reminds me sort of like the Surface Mining Control and Reclamation Act of 1977, that created OSM, the Office of Surface Mining. If we have problems with OSM, I do not see a reopening of the Surface Mining Act.

I think the same thing could be applied here. If there are problems with the ICC—and again, we do not have any in PCMA—perhaps that is what needs to be looked at from the standpoint of it is a government agency and there are other means other than opening Staggers.

Staggers was a benchmark piece of legislation. In PCMA's eyes, it was something that helped us recapture some of our historic markets, and has helped us get back on the road of recovery.

We are in tough shape in Pennsylvania as far as the coal industry goes, and one of the greatest things that has happened to us has been that, the working relationship with our railroads to try and attempt to get our coal to market.

I will save the rest of the remarks for the written record.

[The statement follows:]

STATEMENT OF JAMES V. SCAHILL, EXECUTIVE VICE-PRESIDENT, PENNSYLVANIA COAL MINING ASSOCIATION

Mr. Chairman, members of the committee, I am James Scahill, executive vice president of the Pennsylvania Coal Mining Association (PCMA). PCMA is a trade association of 96 surface coal mining companies and over 125 related supply and service companies, who collectively represent over 85% of the surface-mined production of Pennsylvania coal. PCMA testified before this subcommittee on July 26, 1983. I am here today to again give a overview of the effect of the staggers Act of Pennsylvania Surface Coal Producers and the Interstate Commerce Commission's Implementation of the Act. Since most of our operators deal with one first class railroad, that overview will reflect a regional bias, with a national perspective being given today by Mr. Paul of AMAX Incorporated.

ONE HUNDRED YEARS—A HISTORICAL PERSPECTIVE

Railroads have played a unique role in our history, providing this country its second system of mass transit of both people and commodities. By the 1880's, railroads were the dominant means of transportation, replacing our river and canal systems. Every aspect of commerce was eventually touched by the rail system and there was no question that they held vast market power. Alternate means of bringing goods to market simply did not exist. Abuses of that power resulted in Congress establishing the Interstate Commerce Commission [ICC] one hundred years ago whose function was to regulate rail rates and services. Subsequent amendments through the Hepburn Act of 1906 [gave ICC decisions full force of law]; the Mann-Elkins Act of 1910 [ICC power to suspend rates without shipper complaint]; and the Transportation Act of 1920 [gave ICC power to establish minimum rates, "redistribution" of excess profits, rate adjustment power] broadened the powers of the ICC and expanded regulation.

It is interesting to note that during the same time period and subsequently, the Federal Government promoted the development of alternative modes of transportation, especially after World War II. According to a 1977 Department of Transportation study, the thirty year period after the war experienced the following Federal spending:

	Billion
Highways	$81
Airport/Control	24
Inland Waterways	10
Railroads	1

One of the salient points to be made here is the fact that of all the transportation modes available, and with the exception of pipelines, only the railroads owned and maintained their "roadbeds" at their own expense. Over 2 million miles of highway has been built, including over 40,000 miles of interstate. Over 20,000 miles of inland waterways are maintained by the U.S. Corps of Engineers. Transportation of people was lost to the airlines and the automobile, and railroads faced stiff competition in the transportation of bulk commodities from truck and barge operators who were not constrained by rate regulations or paying a "fair share" for the routes they utilized. The steady erosion of rail traffic and revenues ensured. According to the association of American railroads, ". . . .through much of the post World War II era, many railroads consumed themselves. The large scale of rail plant and the existence of long-lived assets masked the financial plight of many railroads. . . .until it was almost too late."

We in Pennsylvania are acutely aware of what happened. In 1970, the Penn Central filed for bankruptcy, followed in the next six years by approximately 21% of the country's rail route mileage. A PCMA member, C. Alan Walker of Bradford Coal Company, Clearfield County, testified before this committee in 1983 concerning what his company experienced during the 1970's and the effect the collapse of the rail system had on the coal industry in Pennsylvania. Fortunately, that collapse led Congress to act. In 1970, Congress passed the Rail Passenger Service Act which relieved railroads of the social responsibility of operating money-losing intercity passenger trains by forming Amtrak. In the four years prior to passage of the act, passenger operations had cost private railroads over $1 billion [Source: AAR]. It also passed the Emergency Rail Services Act of 1970 which provided Federal loan guarantees fo bankrupt railroads. Finally, Congress created Conrail from six bankrupt carriers including the Penn Central through the Regional Rail Reorganization Act of 1973 (3-R Act).

All of this set the stage for a change in philosophy on how to run a railroad. For the first time since 1887, Congress began to evaluate the damage caused by rate regulation. In 1976, it passed the Railroad Revitalization and Regulatory Reform Act (4-R Act). The 4-R Act authorized capital loans to troubled railroads, and provided the first glimmer of deregulation since 1887 for the railroads. It also set the stage for formulating the implementation procedures of the ICC. The 4-R Act set standards for the ICC to follow. For instance, the ICC was given the authority to eliminate rate regulation over certain types of rates. Also, rates that equaled or exceeded variable cost were not to be held up. The ICC was instructed to develop rate-reasonableness standards that considered the revenue needs of the railroads as part of the rate. From the literature available, most of the criticism leveled at the ICC can be traced to interpretations by the ICC of this act.

The stage was set for further deregulation, and Congress passed the Staggers Rail Act of 1980. While short of wholesale deregulation, the act nevertheless substantially eased the regulatory burden on the railroad industry, providing significant changes in rules governing rate making, car control and other areas in the industry. Historically, the coal industry has depended upon the railroads for the majority of the transportation necessary to get its product to market. The Staggers Act was welcomed by the entire coal industry, PCMA included, in 1980 as a method to force competitiveness among railroads. By 1983, there were those in the coal and other industries who had changed their mind, and advocated opening the act to amendments. Curiously, most of the opinions expressed in 1983 through today have no problems with the act itself, only its implementation by the ICC.

THE STAGGERS ACT

PCMA members are serviced by three first class railroads [Conrail, B&O, and Pittsburgh & Lake Erie] and several third class ones. Regardless of origin, the vast majority of association members ultimately end up on Conrail; therefore, it should be understood that our opinions are based on our experiences with that particular railroad. Also, it is important to note that most PCMA members are classified as "captive shippers."

Our operators' experience with the results of the Staggers Act has been generally favorable. Deregulation through the act has brought about a competitive environment that shippers have found refreshing. Our operators can truly negotiate contracts with the railroads on a competitive basis. The Staggers Act altered restrictive business practices of the railroads and returned decision making back to management. The most extensive changes are in the provisions for rate making. While protection for rail-dependent shippers was retained, it was the intent of Congress that the Disciplines of the Competitive marketplace control most rate making. Rate provisions under Staggers has curtailed the activities of rate bureaus and phased out general rate increases, while offering flexibility in setting rates instead. Before Staggers, the coal industry was hampered by rail rates that could take up to two years to change, resulting in the shipper absorbing any increases in the overall delivered price of coal sold in the marketplace. Today, those rate changes have been accomplished in a matter of days.

To that regard, Conrail utility coal rates have fallen 14% since passage of the Staggers Act, with most of the decline occurring since I last appeared before this committee in 1983. [Exhibit A] those rates have fallen because under Staggers utility customers have been able to find or create competition and use that competition to move the rates downward. [Exhibit B] alternative sources of coal, alternate fuels, and purchased power have all played their role.

One of the greatest results achieved through passage of the Staggers Act has been the rebuilding of this Nation's rail system and rolling stock. Staggers has helped in the restoration of efficient, reliable rail service. As Mr. Walker stated in 1983, "In the mid-70's I did not know whether my coal would be loaded, then whether it would make it to its destination without a derailment or other time delay, or whether it would even arrive at the right destination at all." All of the major railroads have reduced operating costs and operate more efficiently. A salient point is that the ability to compete has enabled the railroads to spread fixed costs over greater volumes. Improved, reliable service cannot be discounted in any discussion about the impact the Staggers Rail Act on the coal industry, at least in Pennsylvania.

One other impact area needs to be examined. As mentioned, the Staggers Rail Act loosened the regulatory knot around not just the railroads' necks, but also the shippers' necks. The ability to negotiate rate contracts greatly enhanced the ability of our operators to market their coal. As I mentioned in 1983, passage of the Clean Air Act of 1970 crippled Pennsylvania coal due to its medium to high sulfur content. Not only did we lose a railroad, we lost our traditional markets during the same time period. The modernization of loading facilities can enable a shipper to receive a reduced rate if they can show Conrail a reduction in the cost to the railroad to load the coal. In the past, a shipper paid the same fixed rate regardless of the efficiency of his operation. Instead of a market dominant railroad exerting that considerable power, PCMA operators have found in Conrail a partner willing to aggressively market our coal. It refurbished a loading pier in Philadelphia to provide competition in the export market. I might add that Conrail took the lead in a remarkable endeavor to market not just one State's coal, but two. Known as the "West Virginia Strategy," Conrail reduced the rates for low-sulfur west Virginia coal being shipped to Pier 124 to encourage blending with higher sulfur Pennsylvania coal.

Pennsylvania coal operators work hand-in-hand with their railroad to market our coal. Conrail contributed to the publication of a PCMA marketing brochure. When the time comes to develop a strategy to combat imported electric power from

Canada to New England, we feel confident that Conrail will be working with our operators towards that end. At the 1983 hearing, Senator Danforth chided me humorously as being a good "cheerleader" for Conrail. I accept that, for is that not what the passage of Staggers was to accomplish, for the rail industry to provide marketing competition for their customers. It should be pointed out again that we are basically captive shippers.

ICC IMPLEMENTATION OF STAGGERS

Volumes of testimony, both pro and con, will be gathered by this committee concerning the need to open the Staggers Rail Act of 1970 to amendments. As mentioned, I have yet to hear or read anything that suggests that there are any flaws in the Act itself. To the contrary, the Staggers Rail Act has been hailed as a benchmark piece of legislation. All that one hears centers around the implementation of that Act by the ICC. Interestingly, the ICC predates the Staggers Act by 93 years as a regulatory arm of Congress. Without going into the specifics of the proposed legislation, I believe that the simple point can be made. Why open Staggers at all when the perceived problem lies with program guidance interpretations by a government agency. Let me use an example near to the coal industry's heart. Congress passed the Surface Mining Control and Reclamation Act in 1977. Changes that will occur to the regulatory arm that enforces provisions of that act, the Office of surface mining [OSM], will not entail opening that act, even though that particular act created the regulatory body.

As captive shippers to Conrail, PCMA members have yet to file an rate dispute with the ICC. In fact, there are no coal rate disputes within the Conrail system, according to them. Given our treatment by the rail industry, it is difficult for Pennsylvania surface coal operators to even begin to understand the problems, let alone the need for legislation. In comparing the devastating collapse in the 70's of the Penn Central to the dependable service given today, in our eyes the system has been fixed. In PCMA's opinion, that mending occurred through passage of the Staggers Rail Act. If other regions are experiencing difficulty, we urge Congress to address them through policy. Naturally, our fear is that opening the act might result in a return to Pennsylvania coal once again being the "coal of last resort."

CONCLUSION

The Pennsylvania Coal Mining Association believes that enactment of the Staggers Rail Act of 1980 was the singular piece of legislation that has saved the rail system of this country. It permits railroads to set their rates in response to market forces; allows railroads and shippers to enter into contracts; assures that private capital will continue to be invested in railroads; and has resulted in Pennsylvania recapturing markets lost in the 1970's. We ask that any "fine tuning" of the Interstate Commerce Commission be accomplished through changes in policy and not by altering one of the greatest accomplishments of the U.S. Congress. We ask that the Staggers Rail Act of 1980 be allowed to stand on its own merit.

Senator ROCKEFELLER. Thank you very much, Mr. Scahill.

Secretary Bergland and all of the others on the panel, I have to be gone for about 25 minutes and, there being no other member here, I think it would be good to recess for that time. There may be time to get something even to eat. So let us come back at 1:00 o'clock.

We will stand in recess.

[Recess.]

Senator ROCKEFELLER. Why do we not begin.

Secretary Bergland had to go and I know there will be, at least from me, some questions submitted for the record to Secretary Bergland.

Mr. Paul, why do I not ask you a couple of things. I must say I found it interesting to compare your testimony with the railroad executives and what they had to say. Basically, what they are saying is that they have only been able to stay in business and do as well as they have because of two things. One is the tax bill and the other is their efforts on the side of productivity and cost savings.

Well, let us leave the tax bill aside for the moment. The coal industry has taken a lot of steps, too, to become much more productive, as is indicated in your chart. In fact, if your chart is correct, the coal producers have done every bit as much as the railroads to become productive, and there has been an extraordinary record.

In fact, if you look at the coal industry and labor over the last ten years, it is probably the great untold story in industrial relations in this country in terms of the increases on both sides to try and make this whole thing work.

The Japanese and others no longer complain about lack of cooperation in the coal fields. The product is delivered on time. There are not the problems with wildcats, TRO's, strikes, et cetera, missed days, that there used to be. It is a wholly different situation.

It is not just the railroads that have done something quite extraordinary. So has the coal industry, and I know you would agree with that.

But when you compare rail coal hauling rates and mine mouth coal prices, as you do on that chart, it seems you are not allowed to keep the benefits of that productivity. That is my impression. I am interested in your comments.

Mr. PAUL. Well, I agree wholeheartedly. I have been involved with the industry for almost 20 years, and I do not remember a period during that time when there has been so many improvements.

We generally try to, as you say, improve our labor relations. We have gone to great lengths to use new and develop new equipment and new means. Everybody is working very, very hard in a very, very difficult market.

And I did not realize until we prepared for this testimony how high the number was on there, and it is very dramatic. And at the same time, I can never remember as long, wide, and deep a depressed situation as we are experiencing now and have been for the last four to five years.

And when I made my other comment before, I was serious. I have sat and listened to a number of hearings on this matter, and this partnership thing kind of disturbs me, because I think if anything is clear when you look at those charts and those lines, a partnership is supposed to be a sharing, I believe, of the risks and the benefits, and it looks to me that it is clear from that chart that it is clear that we are taking all of the risks and getting none of the benefits.

Senator ROCKEFELLER. It certainly is very clear.

Now, one of the points that the railroad folks did not decide to answer this morning was this question of, is it a fact that the captive shippers are in fact paying for the profits of the railroads, that the profits of the railroads, approximately $1.4 billion, are in fact off the captive shippers?

And they wandered around here and there, but Dempsey, Mr. Dempsey, who was speaking for the railroad people, indicated earlier, not today but before, that at a 180 percent ratio the industry would have been in the red by $77 million, which more or less tells me that everything below the ratio line is in trouble, not just the 112 percent ratio on the piggybacking, but that they are getting carried by everybody above the line, everybody above 180 percent.

I would casually observe that captive shippers are giving the railroads their entire profit picture. Would you agree with that?

Mr. PAUL. I cannot say that we are giving them the entire profit picture, but it is clear—and I was also disturbed this morning. All four of the gentlemen seemed—not seemed; they did say they were talking about like we have ten percent captive shippers in our system, and particularly the BN's statement, and then they made the comment about, well, when the Chicago & North Western came in, all of a sudden there was competition in the Powder River Basin.

Well, we were the first in the Powder River Basin, at least in the southern Powder River Basin. The BN does not have any competition north of Gillette. The Chicago & North Western comes in south of Gillette. And they talk about all of a sudden the Powder River Basin has been opened up and it is not true.

And there are very large numbers of captive shippers throughout the country on their systems.

Secondly, one thing that chart does not dramatically show is it does not show the captive shippers. If you look at that chart, that is all coal, all shipments.

Now, if that is what is happening on the average and we believe and you just stated, and I agree with you, that we the captive shippers are carrying the large burden of profitability—I do not know where; we do not have the means to do it—but somewhere on that chart way up—you need a bigger piece of paper—is what the captive shipper is paying, because that chart shows the average of all coal.

Senator ROCKEFELLER. It is only the average, and you are exactly right.

Let me continue on my point then. Mr. Dempsey, also said in 1985—and that is the last; we do not have the 1986 figures yet—the industry's rail operations before taxes and after fixed charges generated income of $1.4 billion, okay.

Then he says, if an absolute ceiling of 200 percent revenue to variable cost had been imposed on the rail rates, railroad pretax income would have dropped to $400 million, a decrease of $1 billion. Then he says, at 180 percent the industry would have been in the red by $77 million.

Now, in absolute logical terms he is describing that captive shippers are taking on the entire profit picture, because what he is saying at 200 percent, which is 20 percent above the 180 percent level obviously, that they make $400 million. And then he says, if you take it down to 180 percent, which is the cutoff line, they lose money.

So he is saying that the entire profit of the railroad industry is being paid, by their own figures, $1.4 billion is being paid by captive shippers.

Mr. PAUL. And most of that is coal.

Senator ROCKEFELLER. And most of that is coal.

May I just ask you why the Congress should get involved in the dispute between coal and rail?

Mr. Paul. Ordinarily we do not ask for that, and as a matter of fact usually we are up here imploring you not to get into our business. I know that. But I think it was said before, and I know it is in our written testimony, we are not here per se complaining about the Staggers Act.

The coal industry was one of the supporters of the enactment of the Staggers Act, because we depend by the very nature of our business on the railroads and we want a good system. Our problem is that what Congress asked for and what Congress passed has not been properly implemented, in our position anyway, by the ICC.

And I think I remember on the House side last week or the week before when we testified, every member of the subcommittee went to great lengths to basically say, is it not funny or coincidental that every time we have a hearing the chairman of the ICC does something. And our position was, you know, if you are not going to pass the Act that we are asking you to, then we are going to have to have hearings every week, because that is the only way anything is going to get done.

Senator Rockefeller. Let me go to Mr. Skewes for a minute. Mr. Skewes, first of all, I want to compliment you on your testimony and I want to thank you for having come up for this hearing.

What you told is a true life story, obviously. It is yours, which goes back over many, many generations. It is a story that I hear constantly in the state that I represent, the State of West Virginia.

And I can tell you that in past hearings we have had a difficult time getting small coal operators, medium size coal operators, to come to testify before the Committee, because they are concerned that if they do that and come and testify and take a position which might be construed as pro-Staggers or anti-railroad, that they will be penalized, and they are in fear, because they have told me so. Individuals have told me that.

And I want to know if you had any concern when you came up here to testify that in fact, that the railroads might make life a little bit rougher for you as a result of your coming here and testifying.

Mr. Skewes. Yes indeed, I did and I do have. I am concerned.

Senator Rockefeller. All right. Let me ask you something. I want to get these questions on the record. You have done a lot of innovating. You have worked hard with the United Mine Workers, as I take it from your testimony. You have done everything you can in terms of more efficient ways to clean coal, innovative marketing, labor relations, and a lot of other things.

Taking into account all of these innovations that you made and the sacrifices that your workers have made and that you have made, how much has the mine mouth price of your coal dropped, approximately, in the last six years?

Mr. Skewes. Approximately 25 percent.

Senator Rockefeller. Can you put a dollar figure on that, from what to what?

Mr. Skewes. Well, my coal is sold in different ashes, anywhere from seven to ten to twelve. But just to make a general statement comparing it to the rest of the coal in that particular region, in a range that was in the $43 to $48 a ton in 1980, today you are talking about $27 and if you are lucky $30.

Senator **Rockefeller**. Okay. Is there anything more that you can do to make your product more competitive?

Mr. **Skewes**. Well, we are virtually at the end of the rope, so to speak. We have worked with the United Mine Workers, we have worked with our own people, our own coal miners in changes in job classification, and anything that would improve the efficiency.

And we have got concessions, and we have utilized the highest, most productive types of equipment available. We have gone over every kind of conceivable piece of our cost and down to the smallest detail.

Senator **Rockefeller**. Would it be fair, if I wanted to quantify this, would it be fair to say that it would not be untypical, if these were some of the prices involved, but you tell me if they are not, that around 1980 your prices were maybe between $43 and $48 a ton, and now they are down to about $27 to $30 a ton in 1986?

Would that be a fair range?

Mr. **Skewes**. That is right.

Senator **Rockefeller**. During the same period in which your prices have dropped, then, by that amount, 25 percent or more as you describe it, what has happened to your rail rate?

Mr. **Skewes**. Nothing. As far as I can see, it is exactly the same as it was.

Senator **Rockefeller**. When the railroad folks have dealt with you on this and you have explained to them that you may have to close up if you cannot get a better rate out of them and in fact that is going to hurt you and it is going to hurt them, have they been responsive to that?

Mr. **Skewes**. They have responded by saying that they are very appreciative that I have stayed and worked there in the areas that were tough and I found coal that they did not even know they had, and that I have established and targeted new markets and have brought in new cleaning facilities and new cleaning techniques that put coal on their railroad that they were not accustomed to having, such as 10 and 12 and 14 ash coal, since the market down there was mostly basically a 6 ash metalurgical coal.

They are very appreciative that I have done these things and that I am establishing new markets. However, they never seem to get around to helping me. And as I tell them the time is running out, they seem more and more interested, but less and less responsive to do anything.

Senator **Rockefeller**. Would it be your position that they have really nothing more that they could give you? I mean, have they cut their costs? Are they at their margin? Is there nothing more they can do to help you in your view?

Mr. **Skewes**. Oh, yes, there is something they could do. I think that they could, if they, whoever and however from the chairman of the board on down, when they make up their mind and recognize totally that here is a declining coal reserve and here is a natural reserve of people who have worked and lived all their lives and know how to make that field continue for many years, when they all get that completely understood in their minds, they should be able to do something about it.

And it is beyond my comprehension why they have not been able to do that to this day.

Senator ROCKEFELLER. What is the price of their getting your coal from your mine to their port?

Mr. SKEWES. It is $15.41 is the established freight rate from McDowell coal fields to Lambert's Point, and then there is about 59 cents to load it onto the vessel at the port.

Senator ROCKEFELLER. Now, you have been selling your coal, as you have indicated, overseas and I understand that is France, Turkey, Egypt, is that correct?

Mr. SKEWES. That is correct. Basically, those are the primary.

Senator ROCKEFELLER. Which is called trying to do something about the trade balance, right? I mean, that may not be your objective, but in effect it is what is happening.

Mr. SKEWES. You are right on target there.

Senator ROCKEFELLER. If you cannot work with the railroad, if you cannot get yourself in a more competitive position, if you cannot sustain yourself in business as you have hinted you might not be able to do, is it likely that another American coal outfit in West Virginia or from Appalachia might pick up that French, Egyptian, or Turkish market, or would it go elsewhere?

Mr. SKEWES. Well, the French business would go elsewhere. It would probably go to Australia.

Senator ROCKEFELLER. It would go to Australia?

Mr. SKEWES. Yes. The people from France have already been over here and talked to the vice president of the Norfolk Southern and explained to him that, without cooperating with and trying to help, that if that is new business for the Norfolk Southern and when they lose me that business will go back to Germany or Australia, in other words that market will not be on the Norfolk Southern unless I produce it.

Senator ROCKEFELLER. So what you are saying in effect is that those contracts will cease to be American contracts, that they will probably become Australian contracts?

Mr. SKEWES. That is definitely correct.

Senator ROCKEFELLER. Which is something of a problem already, is it not?

Mr. SKEWES. Indeed.

Senator ROCKEFELLER. Let me ask you one more question. There's been a lot of talk this morning and early this afternoon about railroads being delighted to talk with shippers if there are any problems. Mr. Lewis said that, and Chairman Gradison indicated this morning that the process was really relatively easy to get into.

Is that your impression of getting the attention of the railroads or getting the attention of the ICC? Do you sort of feel like you can call on Mr. McKinnon and say, you and I need to talk, Mr. McKinnon; or if you had a further problem, getting to the ICC, doing the work, getting ready to prove market dominance and other things—well, you do not have to do that now, but revenue adequacy, rate reasonableness, and all the rest of it, is that something that strikes you that you could just plow right into and get yourself heard pretty easily?

Mr. SKEWES. I think I would get heard pretty easily, yes. I think it is going to take all of the effort that I can muster just to continue operating without having to politically cover myself in Washington.

Senator **Rockefeller**. But are you financially in a position or in terms of time in a position to do what is necessary to get before the ICC?

Mr. **Skewes**. I certainly am not.

Senator **Rockefeller**. What would be your impression of what you would have to do to get before the ICC?

Mr. **Skewes**. Well, I have asked different representatives of Congress and Senators like yourself, and no one has even encouraged me to try, because they probably felt that I did not have the size or the clout to handle it, and certainly not the money and the people to employ to get it done.

Senator **Rockefeller**. They figure that to prove a stand-alone cost model might take up to a million dollars. Supposing it is only half a million dollars, you do not have—that kind of money to do that, do you?

Mr. **Skewes**. No, sir, at this point I certainly do not. It is out of the question.

Senator **Rockefeller**. Thank you very much.

Mr. Scahill, representing the Pennsylvania Coal Association, based upon your experience in Pennsylvania, do you have captive coal mines in Pennsylvania?

Mr. **Scahill**. Yes, sir, we do.

Senator **Rockefeller**. You are not, as I understand it, in favor of the Consumer Rail Equity legislation?

Mr. **Scahill**. No, sir. We again are like most people, we have not really adopted—our board has not adopted an official position. But we have not favored the CURE Act.

Senator **Rockefeller**. And you have arrangements with Conrail, as I understand it, which are most favorable?

Mr. **Scahill**. I believe that the working relationship that our producers have——

Senator **Rockefeller**. I am not talking about the working relationship. I am talking about the contract price relationship.

Mr. **Scahill**. As an association?

Senator **Rockefeller**. Well, not as an association, but the people that belong to your association.

Mr. **Scahill**. Company by company, yes, sir.

Senator **Rockefeller**. So it is a rather good relationship in terms of price that you have with Conrail?

Mr. **Scahill**. Yes, sir.

Senator **Rockefeller**. It is highly satisfactory to you?

Mr. **Scahill**. Yes, sir.

Senator **Rockefeller**. When a coal mine is in fact captive to a railroad, is it not true that you depend upon them to help you in the competitive effort to market coal?

Mr. **Scahill**. Yes, sir.

Senator **Rockefeller**. Do you believe the ICC has done a good job of implementing the shipper protection part of the Staggers Act?

Mr. **Scahill**. As I mentioned earlier, we do not have any filings with the ICC because of that working relationship with Conrail, because of that marketing, that Conrail is the one railroad. And again, I have to say that we are—this is a regional biased look because of that one railroad in our market areas, in our coal mining areas.

But basically, we have not had any dealings—and I researched the 96 companies and we just have not had any dealings with the ICC per se.

Senator ROCKEFELLER. Did your association support the purchase of Conrail by the Norfolk Southern?

Mr. SCAHILL. No, sir, it did not.

Senator ROCKEFELLER. And why was that?

Mr. SCAHILL. We did not feel that the purchase of Conrail by the Norfolk Southern would be in the best interest of the Pennsylvania coal industry.

Senator ROCKEFELLER. I am thankful to you, Mr. Scahill. The Pennsylvania Coal Association appears to like things the way they are.

And are you, Mr. Scahill, aware that the Keystone Bituminous Coal Association disagrees with your position?

Mr. SCAHILL. Yes, sir, I am. They are about two doors down from me in Harrisburg. We work together on a lot of things and some things we disagree on.

Senator ROCKEFELLER. And is it true that about 50 percent of the bituminous coal production in the state of Pennsylvania is done by them?

Mr. SCAHILL. Yes, sir. If I could expand on that for a second, PCMA or the Pennsylvania Coal Mining Association, is the surface industry in Pennsylvania basically, with about 45, 46 percent of the tonnage.

Keystone Bituminous Coal Association basically is the underground association. The companies that belong to Keystone are basically underground, although they do have—there is a crossmatch. I have three underground operators in my association and they have maybe half a dozen surface operators in their association.

If you look at the map—I do have a map with me that I would give you and could submit for the record. If you look at the rail map, it closely correlates to the underground, the main underground area, which is southwestern Pennsylvania, the closest neighbors to West Virginia. Basically, you are talking more in the Chessie System, you are talking not Conrail.

We are, in the surface industry, are not basically in Washington, Greene, Fayette Counties, which is that biggest part of what I would call the Keystone representation, the underground mines.

Conrail does have the Bailey Mine for the Consolidated Coal Company.

Senator ROCKEFELLER. I understand that, and you have helped me. You have made some of the points I was going to make about Keystone, that they do include more than 85 percent of the underground mining.

Mr. SCAHILL. I would say they are more like 95 percent. They are almost the entire underground industry.

Senator ROCKEFELLER. And I want to submit for the record a letter to me from John Shervinsky, who is the President of the Keystone Bituminous Coal Association, dated June 15, 1987, in which he gives his strong support to the Consumer Rail Equity Act.

Gentlemen, I am grateful to you, as I indicated earlier. I will have questions and I am sure other members will, and we will keep the record open for that for Secretary Bob Bergland.

And I am grateful to each of you for taking the time to come here.

The final panel is agricultural shippers: Mr. William Harding, Chairman, Transportation Committee, National Grain and Feed Association; and Mr. George Berg, Assistant Director, National Affairs Division, American Farm Bureau Federation.

Mr. Harding, you are welcome. We are very glad you are here, sir, and you are welcome to begin.

STATEMENTS OF WILLIAM C. HARDING, CHAIRMAN, TRANSPORTATION COMMITTEE, NATIONAL GRAIN AND FEED ASSOCIATION; AND GEORGE BERG, ASSISTANT DIRECTOR, NATIONAL AFFAIRS DIVISION, AMERICAN FARM BUREAU FEDERATION

Mr. HARDING. I am vice president, Transportation, for the Louis Dreyfus Corporation and, as you mentioned, Chairman of the Transportation Committee for the National Grain and Feed Association.

In my testimony before the subcommittee during the last Congress, I told the members that Staggers and the 4-R Act were the source of great benefit to many shippers, including shippers of grain. In fact, grain rates have been repeatedly used as a rationale for no change from the status quo.

However, often overlooked in these claims in analyzing the benefits of Staggers was the fact that a tremendous excess of transportation capacity created a buyer's market for transportation. As an example, during the period from October of 1980 to October of 1986, the time frame railroads use to show a 28 percent decline in rail rates for grain, barge rates for grain went down by at least 42 percent.

From our standpoint, there are many other accompanying effects of the Staggers Act that pose a real threat to a competitive marketplace and warrant action by Congress. Six years experience under the Staggers Act has demonstrated over and over again the ICC's failure to take a balanced approach to regulation.

For this reason, our association supports statutory changes to the Act. We believe that further direction clarifying the original intent of Congress in several key areas of the Act must be given to the ICC.

As an aside, it is interesting to note that the Canadians are currently considering another round of deregulation of their railroad industry. Chief among their list of priorities is to modify their competitive access policies, including terminal access, switching, and joint rates. Their goal is to ensure that Canadian shippers do not have to face the same problems that U.S. shippers have had with Staggers.

It is rather ironic that, even with the dramatic shrinkage of rail alternatives in the U.S. market, the ICC continues to interpret the statute in a very restrictive manner, while in Canada the proposals to date are intended to spur competition.

There are several provisions in what we view as the primary legislative vehicle, S. 676, of particular importance to shippers of grain and grain products. Unquestionably the most important of these amendments concerns competitive access and the access of privately owned equipment.

As concentration in the railroad industry continues to grow through mergers and acquisitions, competitive access issues become more critical than ever to the maintenance of a competitive rail transportation system.

The grain industry has been particularly hard hit by the closure of joint rates and routes and the cancellation or increased cost of switching agreements. Numerous instances of inter-carrier disputes exist where the victim is a shipper who loses access to a potentially profitable market.

For example, private economic studies have shown that 180 percent of actual variable costs to switch unit trains averages approximately $30 a car. It is interesting to note that in Canada, where switching is fixed by law at one and a half cents per hundredweight, that the switch on a 200,000 pound grain car would also equal $30 a car.

In today's market we are seeing switching charges for selected interchange points as high as $300 to $400 per car. Obviously, switching charges at this level are not justifiable on the basis of cost, and are intended solely to block access by other carriers and limit marketplace competition.

The grain industry is characterized by its strongly competitive nature. Although viewed by those in some industries as extreme, the fact that someone else may freely enter a market and may be willing to better your offered price keeps a check on price levels and market behavior. In the grain marketplace, competition is so keen that a competitor may attempt to beat my price by bidding grain out of and using my facility.

We believe that a similar competitive framework, both intra and intermodal, should be the basic right of shippers and, where necessary, regulatory relief should be relatively simple to pursue in order to ensure a competitive marketplace, as was intended by Congress.

Another related area of anti-competitive behavior by railroads concerns the usage of privately owned cars and compensation for the use of privately owned covered hopper cars. This issue has not yet been addressed by legislation, but is nonetheless an integral part of our competitive access concerns.

Just as railroads attempt to deny access to their lines by competing carriers, they also attempt to deny entry to private hopper cars in an effort to monopolize carriage in their own equipment. The covered hopper car is virtually the exclusive railroad vehicle for moving grain and several other types of dry bulk commodities.

Throughout the 1970's and into the beginning of this decade, a chronic and severe shortage of covered hopper cars existed, at times reaching as much as 30,000 cars per day. In response to Interstate Commerce Commission encouragement and marketplace needs, shippers began supplying their own covered hopper cars, and by 1982 shippers were operating nearly 76,000 grain type covered hopper cars, or 44 percent of the entire fleet consisting of that type of car.

For the first time in the history of the railroad industry, there was genuine competition in the supply of equipment, and it worked very well.

In the spring of 1983, a group of shippers and hopper car suppliers filed a formal complaint proceeding assailing the railroads' asserted right to veto the use of the private covered hopper cars on several grounds. Voluminous evidence was introduced by both the shippers and the railroads.

In September of 1984, the Administrative Law Judge found that although railroads had an historic common carrier obligation to supply cars; different considerations should be applied to the future that would allow shipper cars access into the market. And he called for negotiations between shippers and carriers.

After this decision was issued, the railroads fought against any negotiations for over a year and, although they are now negotiating, they have made few concessions.

The issues of private care access and compensation remain questions with anti-competitive overtones. Right now, many grain companies are finding it difficult and at times impossible to obtain an adequate number of railroad cars. What was a sizable surplus of covered hopper cars four or five years ago is rapidly disappearing and in fact we face a car shortage again on most U.S. railroads.

So in the area of private hopper cars, we have re-emerging shortages of capacity, railroad insistence that they can veto the use of private cars, thus making themselves the prime supplier of the car capacity where and when they so choose, and railroad claims that the laws of supply and demand should govern compensation so long as they control supply.

We have prepared some draft language that we feel addresses the concerns we have just expressed about hopper cars.

And I would like to thank you for your attention today.

[The statement follows:]

STATEMENT OF THE NATIONAL GRAIN AND FEED ASSOCIATION

Mr. Chairman and members of the subcommittee.

My name is William C. Harding. I am Vice President of Transportation for the Louis Dreyfus Corporation of Stamford, Connecticut. As chairman of the Transportation Committee of the National Grain and Feed Association, I am here today to enter this statement on behalf of the Association.

The National Grain and Feed Association is a voluntary association of grain and feed firms ranging in size from the smallest country elevator to the largest grain and feed complex. Included in our membership are country and terminal elevators, merchandisers, processors and exporters covering the wide spectrum of the grain and feed industry. In addition, there are 40 state and regional grain and feed associations affiliated with the National Grain and Feed Association whose membership includes more than 10,000 grain and feed companies nationwide.

During the 99th Congress, I had the opportunity to testify before this subcommittee on rail issues. I testified on what the members of the National Grain and Feed Association believed were the major problems and shortcomings of the Staggers Rail Act of 1980. I indicated that, in general, our concerns centered around the competitive access issues of switching, joint rates and routes, terminal access and access of privately owned rail cars. I also told the members of the subcommittee that the operating freedom given to rail carriers through deregulation under Staggers and the 4-R Act, was the source of great benefit to many shippers, including shippers of grain. Often overlooked, however, in analyzing the benefits of Staggers was the fact that the tremendous excess of capacity created a buyers' market for transportation.

I also noted that in addition to beneficial aspects, the Staggers Rail Act contained provisions that were being improperly interpreted by the Interstate Commerce Commission, resulting in some very threatening detrimental impacts to competitive rail service. My purpose today is to relate to the committee, actions that have or have not transpired in the past year to address our concerns, and to restate our position that we believe that certain statutory revisions to Staggers are needed to more completely balance the interests of carriers and shippers.

Mr. Chairman, the grain industry is characterized by its strongly competitive nature. Although viewed by those in some industries as extreme, the fact that someone else may freely enter a market and may be willing to better your offered price, keeps a check on price levels. In the grain marketplace, competition is so keen that a competitor may attempt to beat my price by bidding grain out of and using my own facility.

The members of the National Grain and Feed Association believe that the concerns we have with the Staggers Rail Act, and its interpretation by the ICC stem from a great lack of intra-modal competition between carriers on an increasing percentage of grain movements. We feel that rail carriers, similar to the grain industry, if properly policed by competitive forces, will lose the ability to monopolize traffic to a particular line and thus reduce the likelihood for anticompetitive activities. Accordingly, we come here today urging statutory corrections in the areas of "competitive access" or access to lines by competing carriers and in the area of rail equipment access.

As an aside, it is interesting to note that the Canadians are currently considering deregulation of their rail industry. Chief among their list of priorities is to modify their competitive access policies. In so doing, the Canadian House of Commons is reviewing the competitive access components of terminal access, switching, and joint rates.

It is rather ironic that even with a dramatic shrinkage of rail alternatives in the U.S. market, the ICC continues to interpret the statute in a very restrictive manner while in Canada the proposals to date (presumably in reaction to Staggers and to foster competition with U.S. carriers) are intended to spur competition.

COMPETITIVE ACCESS

Similar to last year, it is our position that potentially the most onerous and anticompetitive actions by the nation's rail carriers are those relating to the closing of joint rates and routes; the discouragement of traffic interchange through the cancellation of switching agreements or the setting of switching charges at exorbitant levels; and actions taken by rail carriers to discourage the use of, and fair compensation for, shipper rail cars. Such deterioration of intra-modal competition is intolerable in a free market economy.

The nature of both inter- and intra-modal competition in the rail transportation marketplace has changed dramatically over the past few years, as have relationships between rail carriers and shippers. Some of the changes have been decidedly favorable, while others have created severe economic hardship. But one fact has become increasingly clear. Namely, that competitive alternatives for rail shippers are becoming vulnerable to the unilateral actions and decisions of the rail industry in our preent deregulated environment, and the opportunty for redress before the Interstate Commerce Commission continues to diminish.

The grain industry continues to be hard-hit by the closure of joint rates and routes and the cancellation or increased cost of switching agreements between carriers. Numerous instances of inter-carrier disputes exist where the victim is the shipper who loses access to potentially profitable markets. As you know all too well, it is the farmer that relies on these markets who ultimately bears the brunt of the loss. For example, private economic studies completed about two years ago have shown that 180 percent of actual variable costs to switch unit train cars averages approximately $30 per car. It is interesting to note that in Canada where switching is fixed by law at 1.5 cents per cwt that the switch on a 200,000 pound grain car would also equal $30 per car. In today's market, we are seeing switching charges for selected interchange points as high as $300 to $400 per car.

Obviously, switching charges at this level are not justifiable and are designed to be a barrier to entry and limit marketplace competition. We believe that the situation where carriers can selectively determine for shippers the origin and destination for grain simply by opening or closing a switch is unsupportable by any application of the concepts of free and open competition.

Last year, we were very hopeful that the ICC would take steps toward ensuring a greater degree of competitiveness where it did not exist in the rail marketplace. We felt that even if the Commission would not render market-oriented decisions independently, that at a minimum the interest Congress took in this issue would lead to some positive action. The ICC did take action on the competitive access issue, but from our standpoint, the congressional hammer that was persuading the Commission to take action was put aside a little too soon. Immediately following the full Energy and Commerce Committee's decision to report legislation without competition access provisions, the Commission voted in what we viewed as a landmark case to deny competitive access relief.

In *MIDTEC Paper Corporation, et. al.* v. *Chicago and Northwestern Transportation Company* (MIDTEC) the Commission voted, 3-2, to deny the competitive rail alternatives sought by MIDTEC and by the SOO line railroad. In making its determination, the majority strained to find that a competitive alternative to the CNW was not required because they could find no evidence of "inadequate service or excessive prices." The commission relied upon the interpretation of the Staggers Rail Transportation Policy to find that "inadequate service and monopoly prices" were the dispositive factors of whether competitive access remedies of switching or terminal facility usage would be granted, not the fact that the shipper and a competing carrier were desiring to explore a competitive alternative.

We feel that the Commission has again misinterpreted the act. 49 USC § 10101a *Rail Transportation Policy,* paragraph (1) states "it shall be the policy of the United States Government to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail". It is apparent to us, and to the two members of the Commission dissenting to the opinion, that the marketplace should determine whether or not line haul rates are at competitive levels, and that the only way to determine competitive rates is to provide the means, through switching at a reasonable rate, by which competition can exist. The Commission in the MIDTEC decision, intentional or not, was in effect judging whether market competition should exist. It is our position that competition should exist wherever possible, and should not be provided or rejected due to administrative fancy.

A competitive price structure is very important to the grain industry and all of agriculture. Farmer must compete against farmer, elevator against elevator, railroad against barge and truck, and railroad against railroad. We believe that competition, both intra- and inter-modal, should be a basic right of shippers and where necessary, regulatory relief should be relatively simple to pursue in order to ensure a competitive marketplace as was intended by Congress.

In 1983, our Association conducted a survey which illustrates the severity of the competitive access problem for grain shippers. That survey revealed that not only is the grain industry heavily dependent on the rail mode, but to a great degree, grain shippers are dependent upon a single carrier within the rail mode. In fact, of all surveyed country elevators that are served by rail, 94.3 percent are served by a single railroad. But, the problem does not end with country elevators. The survey shows that of all terminal elevators surveyed, 63.5 percent of these facilities that are served by rail have direct access to only one rail carrier. However, nearly half of these terminal elevators, that are served by one railroad, have the potential to take advantage of traffic interchange within their city's switching limits if switching agreements are maintained by the railroads. This demonstrates the importance of access to open switching at a reasonable cost to this segment of the grain industry.

Our survey showed that all types and sizes of grain shippers, regardless of geographical location, are vulnerable to the anticompetive actions of the railraod industry. The maintenance of competition among railroads is absolutely necessary if grain shippers are going to retain access to competitive markets and access to competitive rail service at a reasonable cost.

Critics argue that grain shippers can gain access to markets and competitive transportation service by shipping via truck or barge. As a practical matter, however, this frequently is not possible. First, the majority of grain shippers are not located contiguous to a navigable waterway. Second, studies have shown that trucking grain to a barge loading point is economically feasible only when the elevator is just a short distance from the waterway. Third, truck shipments of grain generally are viable only for relatively short distance movements. Motor carriage is the most costly method by which grain moves, and it would take nearly 300 large trucks to do the job of a 75-car unit train in shipping grain for export or domestic use. This operation simply does not make economic sense. Others support that contention. In a brief filed with the ICC in the Santa Fe-Southern Pacific merger case, the United States Department of Justice stated: "The economics literature . . . shows that as to the movement of . . . large volumes of low-value commodities for long distances, truck is not an economic substitute for rail."

A number of factors have contributed to the problems faced by grain shippers in their relationships with rail carriers, but the main contributing factor is the lack of enforcement of current law on the part of the ICC and the increasing monopoly power on the part of the railroads resulting from the level of concentration in the industry that has been caused by a series of railroad mergers that have reduced the number of competitors and the level of competition in the industry. This problem is exacerbated in cases where rail mergers have been parallel rather than end-to-end.

In an effort to offer more adequate protection for shippers, the Association of American Railroads and National Industrial Transportation League entered an agreement earlier last year addressing certain aspects of the problems with joint rate and route cancellations, reciprocal switching and terminal access (Ex Parte No. 445 Sub—No. 1). While our association viewed this agreement as making some progress toward more reasonable interpretation of the statute, we have been alarmed by the tendency of ICC to use it to deny competitive relief rather than promote it.

Agricultural and other shippers have been frustrated in attempts to pursue regulatory relief before the ICC. To encourage effective intra-modal competition, the National Grain and Feed Association believes that amending legislation is necessary to define more precisely the intent of Congress. The law should ensure: 1) that railroads join in joint rates and routes where such routes are cost efficient and/or to ensure that at least one competitive rate and route between all supply and demand points; 2) that reciprocal switching be guaranteed at all locations where possible and at a reasonable rate level; and 3) that carriers seeking to provide competitive rail service be permitted the use of terminal facilities, including mainline tracks for a reasonable distance beyond terminal areas, if the ICC finds such use can be accomplished without impairing the ability of the rail carrier owning, or entitled to use, the facilities to handle its own business.

We believe that this competitive access language, which is contained in Section 9 of S. 676, if enacted would accomplish these goals. In principle, these provisons make three changes which are aimed at clarifying for the ICC, the intent of the framers when drafting the Staggers Act.

First, the provision would compel carriers to provide switching where practicable and in the public interest or where such agreements are necessary to provide competitive rail service. We believe that by mandating the availability of a switch, shippers would be provided a competitive alterantive, *if* competition is feasible. In order to ensure that switch is not economically closed to traffic by virtue of a high-priced switch, we have suggested a maximum switch change. This level is based upon some reciprocal switching agreements currently utilized in the industry and upon the threshold level currently in place for rail rates under Section 10709(d)(2).

Second, Section 9 would require carriers to publish a competitive joint rate and route between a particular origin and destination upon request of a carrier that has an interchange with the first carrier. This would operate where the second carrier has the ability to serve the same origin and destination required by the shipper.

Third, the proposal directs the Commission to provide the use of one carrier's terminal facility for the benefit of another carrier to enhance competition. This will be done at the terms and conditions agreed upon by the carriers.

Critics of this section of the bill will argue that if the competitive access provisions are enacted, their ability to control the traffic on their lines would end. To the extent that ending such control means giving another carrier the ability to compete for a particular movement, and shippers a competitive alternative, we are in agreement.

We do not agree that the true competition should be as frightening as our critics make out. Virtually every other industry is kept in check by competing forces, and we submit that the railroad industry should be no different.

We would, however, recommend two language modifications to make it more practically applicable. S. 676 would require the ICC, if petitioned by an interested party (either another carrier, shipper or receiver), to "establish the compensation for reciprocal switching performed by a rail carrier at a level not to exceed the percentage then in effect under section 10709(d)(2) of actual variable costs for such service. . ."

We would urge that the words "system-wide variable costs" replace the phrase "actual variable cost." This change would make it much more simple to pursue regulatory relief under this provision. In addition, all the references in section 9 of S. 676 to "reciprocal switching" should be changed to "switching." The term reciprocal switching is outdated. It implies reciprocity and full absorption of switching costs by line haul carriers, neither condition of which is prevalent today.

We believe that the competitive access provisions contained in S. 676 would not reverse the philosphy that less regulation will enable railroads to prosper in a free market economy. They simply would ensure that as railroads exercise more service and pricing freedom, shippers will be provided with competitive rail environment.

PRIVATE CAR ACCESS

Another related area of anticompetitive behavior by railroads concerns the usage of private cars and compensation for that use. This issue is not yet addressed by legislation, but is nonetheless an interfal part of our competitive access concerns. Just as railroads attempt to deny access to their lines by competing carriers, they also attempt to deny entry to private hopper cars in an effort to monopolize carriage in their own equipment. And railroads now have come up with a brand new argument to apply when they do acquiesce in the use of private cars; they are urging the ICC to circumscribe its jurisdiction over private car compensation—the amount railroads are compelled to pay private car owners under Sections 10747 and 11122—making a shipper prove market dominance and after that to make a complex and expensive stand alone cost showing before receiving any private car compensation.[1]

The covered hopper car is virtually the exclusive railroad vehicle for moving grain and several other types of dry-bulk commodities. Throughout the 1970s and into the beginning of this decade, the railroads' supply of those cars was chronically and severely short; the shortage at times reached 30,000 cars daily. In response the Interstate Commerce Commission took steps to encourage shippers to supply their own covered hopper cars, so that by 1982 shippers were operating nearly 76,000 grain-type covered hopper cars[2], or 44 percent of the entire fleet consisting of that type of car. For the first time in the history of the railroad industry, there was genuine competition in the supply of jumbo covered hopper cars, and it worked well.

In the spring of 1983, a group of shippers and hopper car suppliers filed a formal complaint proceeding, Docket No. 39169 *Shippers Committee, OT-5* v. *The Ann Arbor Railroad Company, et al.*, assailing the railroads' asserted right to veto the use of private covered hopper cars on several grounds. Among these were the contention that it would be inequitable for the Commission to turn its back on a private car fleet which the Commission, itself, had solicited into being; that it would be inequitable for the railroads, who had not merely failed to provide necessary equipment but had sought to induce shippers to supply their own cars through such devices as rates which were applicable only if shippers did, in fact, provide cars; and that it was anticompetitive, and discordant with the thrust of deregulation, for the railroads to assert the right ot be the sole suppliers of covered hopper cars, just as the FCC and the courts had found that it was anticompetitive for the Bell System to assert the right to be the sole supplier of telephone equipment.

Voluminous evidence was introduced by both SCOT-5 and the railroads. In September 1984, an Administrative Law Judge found that, although railroads had an historic common carrier obligation to supply cars and thus a concomitant right to do so to the exclusion of cars supplied by others, different considerations should be applied for the future.[3] The Judge concluded that "it will be unreasonable and unlawful for defendant railroads in the future to exclude entirely from their lines the privately owned covered hopper cars of SCOT-5 members and other shippers and that continued access to those lines by such cars must be assured by an equitable sharing formula subject to reasonable terms and conditions." He then directed the parties to attempt to negotiate such a formula, failing which he stated that the Commission (presumably through a further order that he would issue initially) would resolve the problem itself.

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[1] These arguments have been advanced by the railroad industry as a group in ICC docket No. 39117, *LO Shippers Action Committee* v. *Aberdeen and Rockfish Railroad et al.*, and individually by major railroad in ICC docket No. 37626, *Consolidated Papers Inc. et al.*, v. *Chicago & Northwestern Transportation Co., et al.*

[2] The device which the ICC gave grain shippers is typified by the following excerpt from a speech given by an ICC official (then Director of the Commission's Bureau of Operations) in November 1978 before the Montana Grain Growers Association:

"First, I believe it behooves each of you to assess your capability to acquire and utilize your own private car fleet. If your company is large enough or if you can combine your operations through cooperatives or other similar associations to lease or buy your own freight cars, I believe that you might find it in your best interest to do so."

[3] The Judge made the following findings: ". . . The evidence clearly establishes, however, that it is not and never has been the intention of defendant railroads, individually or collectively, to acquire and maintain covered hopper cars in adequate number to handle all of the grain and other traffic that may reasonably be expected to be tendered to them for movement. . . . The conclusion is inescapable that the existence of a viable fleet of privately owned cars will continue to be essential to supplement the carrier, in the future as in the past. Defendants have made it as plain as can be, on the other hand, that they intend to maximize use of their own cars, particularly during periods of car surplus. . . . If this occurs, it is necessary to consider whether the privately owned car fleet can survive, hanging by its fingernails as it were on the fringe of this transportation movement, whether without some concrete assurance of regular use the privately owned cars will be there when they are needed."

After this decision was issued, the railroads fought against any negotiatons for a year. Altough they are now negotiating, they have made few concessions, perhaps believing they have an eventual ally in the ICC.

The ICC in fact, has recently voted the railroads a major victory in the area of private cars. In the *LO Shippers Action* case the Commission voted on Feb. 24, 1987, to do away with a cost of ownership formula for compensation payments to shippers who furnish their own cars, and to leave compensation questions to a case-by-case determination. But the Commission has not enunciated the values or considerations that will apply in those individual cases.

The issues of private car access and compensation remain questions with anticompetitive overtones. As recently as the past grain harvest many grain companies found it very difficult, and at times impossible, to obtain an adequate number of railroad cars. What was a sizable surplus of covered hopper cars four or five years ago is rapidly disappearing.

So in the area of private hopper cars we have: (1) reemerging shortages of capacity, (2) railroad insistence that they can veto the use of private cars, thus making themselves the prime suppliers of car capacity where and when they so chose, and (3) railroad claims that the laws of supply and demand should govern compensation so long as the railroads control supply. But legal actions have been taken that argue that compensation should be based on market dominance theories that combine the line haul rate with the compensation for equipment.

The ability to obtain and use freight cars supplied from sources competitive to the railroads is important to the gran industry for several reasons. First, the industry has an investment to protect in cars that were acquired as a result of railroad car supply deficiencies, railroad urgings and ICC urgings. Second, we need access to a viable source of competitive car supply to avoid a repetition of those horrendous days when grain rotted on the ground and farmers lost markets due to lack of railroad capacity and when railroads simultaneously assessed premiums for furnishing their own cars which were in short supply. All of us are hopeful that the current doldrums in which we find grain exports will not be permanent. When demand increases, as it must inevitably, it would be an unwarranted abuse of Staggers Act freedoms for the railroads to be able to monopolize the supply of cars or to price their own equipment excessively when others are willing and able to competitively provide alternate capacity.

We have prepared some draft language that we feel address the concerns we have just expressed. Our language would prohibit the ICC from applying to small grain companies in private car compensation cases the same inappropriate burdens now applicable in rate cases. Further the language states that a carrier may not prohibit the entry of freight cars owned by shippers or third persons, except for mechanical deficiencies.

I would like to thank all of the members of the subcommittee for this opportunity to present the views of my Association. I will try to address any questions you might have.

Senator ROCKEFELLER. Thank you, Mr. Harding.

Mr. Berg.

Mr. BERG. Thank you, Senator Rockefeller.

My name is George Berg and I am representing the American Farm Bureau. Inasmuch as my full statement has been submitted for the record, I will try to summarize this as quickly as I can.

I appreciate this opportunity to present the views of the Farm Bureau on the impact of the Staggers Act on agriculture. Obviously, agriculture has a strong vested interest in maintaining a vital and efficient U.S. rail system.

The farm community relies on rail carriers to transport agricultural supplies and to market farm commodities. The nation's freight railroads carried approximately 4.2 billion bushels of grain in 1986.

The Farm Bureau supported the Staggers Act when it was enacted in 1980. Seven years experience with partial rail deregulation has confirmed the success of Staggers. The Act has accomplished the objectives of the Congress. It has saved the rail industry from the threat of costly nationalization, restored a degree of financial health to the railroads, improved rail service for the majority of rail customers, and resulted in a more competitive rail transportation network.

Contracts, both short and long term, were made lawful by Staggers. Contracts permit railroads and shippers to agree on rates and service levels tailored to fit specific needs, and the railroads gain minimum volume assurances that allow improved utilization of equipment and plant and other reduced costs associated with labor and administration.

Farmers gain because contract rates are generally below published tariff rates. A recent survey of major grain-hauling railroads by the Association of American Railroads showed average rail grain rates have fallen some twelve percent since 1984, largely due to the use of contracts.

According to the AAR, average grain rates fell 28 percent between the passage of the Staggers Rail Act in 1980 and the end of 1986. The survey also indicated that about 63 percent of all rail grain tonnage currently moves under contract.

From an agricultural perspective, we believe the system under Staggers is working fairly well. The simple fact is that the farmers' products are being moved better, quicker, and for the most part cheaper, although the farm community has some concerns with the Interstate Commerce Commission's implementation of the Act.

We do not expect to move from 100 years of strict economic regulation to a less regulated environment without experiencing some difficulty. While abandonments continue to be a matter of concern for us, the consequences of branch line abandonments in general have not been as bad as we had feared.

Nevertheless, we support the concept that rail carriers should not be permitted to easily abandon these existing lines.

The ICC's implementation of the Staggers Act has been sharply criticized by some shippers, who believe their traffic is captive to railroads because no viable alternative transportation is available at a price they can afford to pay.

The inequities to shippers created by this situation could become more readily apparent when market conditions for agricultural commodities move from the current surplus dilemma to a period of higher demand. Although we are pleased with the rail rates for grain since the enactment of Staggers, the fact remains that each railroad owns and controls its own right of way, and no other railroad can compete to provide better rates or service.

In the absence of this competition, we believe that rail shippers need a regulatory framework that defines rights and remedies for captive shippers. As you know, to obtain rate relief a captive shipper must first prove his captivity by proving the market dominance of the railroad.

We believe legislation could be introduced directing the ICC to eliminate discriminatory railroad rates between geographic areas of the country and base rail rates on weight, volume, and distance on a uniform basis for all regions.

We believe the ICC should also be directed to develop a clear, precise definition of market dominance and captive shipper that recognizes the realities of rail transportation.

Another area in need of modification is in regard to joint rates and through routes. Grain farmers and shippers need the ability to market their commodities for both export and domestic purposes, unimpeded by artificial barriers that have been erected by some rail carriers.

Under the Staggers Act, artificial barriers in the form of cancelled rates and through routes do not provide for increased competition in the transportation marketplace. The Farm Bureau believes that there should be some refinements of the Staggers Act to provide reasonable joint rates and switching agreements in order to promote the efficient transportation of commodities among different rail service areas.

We believe legislation could be introduced directing the ICC to prohibit railroads from preventing other railroads from competing for traffic by refusing to interchange traffic or refusing to establish competitive rates and charges on through routes and for reciprocal switching.

In the event these directives from the Congress should not prove effective in providing relief for captive shippers, the Congress could consider triple damages to remedy abuses of market power by the railroads in captive shipper situations.

The Staggers Act has improved the efficiency and reliability of shipping goods by rail. Railroads are posting ample profits and they have been investing millions of dollars to modernize their systems. The first goal of rail deregulation, a more productive, financially stable system, has been achieved. Although we see some need for modification, we continue to believe the long-term goal of reform should be to keep easing off regulation by making the shipping industry even more competitive.

That concludes my statement.

[The statement follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

The American Farm Bureau Federation is the nation's largest general farm organization with a membership exceeding 3.5 million families in 49 states and Puerto Rico.

I appreciate this opportunity to present the views of Farm Bureau on the impact of the Staggers Rail Act on agriculture. Obviously, agriculture has a strong vested interest in maintaining a vital and efficient U.S. rail system. The farm community relies on rail carriers to transport agricultural supplies and to market farm commodities.

The railroads need agriculture as much as agriculture relies on the railroads. Farm products are second only to coal as the largest commodity group carried by rail in terms of tons originated. Farm products make up 9.6 percent of total rail tonnage and comprise 7 percent of rail revenue. The nation's freight railroads carried approximately 4.2 billion bushels of grain in 1986.

Farm Bureau supported the Staggers Act when it was enacted in 1980. Seven year's experience under partial rail deregulation has confirmed the success of Staggers. The Act has accomplished the objectives of Congress. It has saved the rail industry from the threat of costly nationalization; restored a degree of financial health to the railroads; improved rail service for the majority of rail customers; and resulted in a more competitive rail transportation network.

An example of rail service before and after Staggers will illustrate my point. Many people recall the transportation snafus that occurred when the Soviets purchased large quantities of U.S. grain in the mid-1970's. In those days, the Interstate Commerce Commission (ICC) could issue car directives to move railcars to areas of high demand. But a system of car distribution by bureaucratic fiat could not keep up with the heavy demand for grain cars at export points. The result was chronic car shortages, major transportation battlenecks and a lot of name-calling between shippers and railroads.

The situation has improved dramatically since the Staggers Act was passed. Although U.S. grain exports dropped significantly in 1985-86, the railroads moved roughly the same amount of export grain in 1983 and 1984 as they did during the height of the Soviet grain sale in 1973--without any significant car shortages. A recent USDA report predicted the current rail car supply will be sufficient for agricultural needs through 1987.

Contracts--both short and long-term--were made lawful by Staggers. Contracts permit railroads and shippers to agree on rates and service levels tailored to fit specific needs. Railroads gain minimum volume assurances that allow improved utilization of equipment and plant and other reduced costs associated with labor and administration. Farmers gain because contract rates are generally below published tariff rates.

A recent survey of major grain-hauling railroads by the Association of American Railroads (AAR) showed average rail grain rates have fallen some 12 percent since 1984, largely due to the use of contracts. According to the AAR, average grain rates fell 28 percent between passage of the Staggers Rail Act in 1980 and the end of 1986. The survey also indicated that about 63 percent of all rail grain tonnage currently moves under contract. Overall, farmers have benefited from contracts because contracts have resulted in higher prices being paid to farmers for their grain.

From an agricultural perspective, we believe the system under Staggers is working fairly well. The simple fact is that the farmer's products are being moved quicker, better and for the most part cheaper. Although the farm community has some concerns with the Interstate Commerce Commission's (ICC) implementation of the Act, we did not expect to move from almost 100 years of strict economic regulation to a less regulated environment without experiencing some difficulty.

While abandonments continue to be a matter of concern for us, the consequences of branch line abandonments in general have not been as bad as we feared. In many cases, railroads have been able to reduce costs and increase densities by bringing more grain to main line points. Reduced rail costs in turn mean lower unit train rates. Some smaller farmers are shuttling grain to larger elevators to take advantage of better rates. Nevertheless, we support the concept that carriers should not be permitted to easily abandon existing lines.

Another outgrowth of rail deregulation has been an increase in the number of local and regional railroads, many serving agricultural communities. Approximately 150 of these "shortline" roads have sprung up since 1980, predominately in rural areas. Entrepreneurs are buying and operating smaller lines that large railroads find unprofitable to maintain. These small railroads are more sensitive to the local shippers, and feed traffic to the trunk line carriers.

The benefits of the Staggers Act far outweigh the problems that still exist and are in need of some modification.

Prior to the Staggers Act, the ICC was responsible for seeing that rail rates were reasonable and nondiscriminatory among a railroad's shippers, among competing locations served by a railroad, and among competing commodities carried by a railroad.

The ICC's implementation of the Staggers Act has been sharply criticized by some shippers who believe that their traffic is "captive" to railroads because no viable alternative transportation is available at a price they can afford to pay.

The inequities to shippers created by this situation could become more readily apparent when transportation market conditions for agricultural commodities move from the current surplus dilemma to a period of higher demand. As the structure of the rail industry evolves toward an even smaller number of Class I railroads, the potential for predatory ratemaking could grow and the danger to captive shippers could become more pronounced. We believe the market dominance question must be modified to take into consideration the realities of commodity shipment and establish a workable agreement for the protection of captive shippers.

Although we are pleased with the rail rates for grain since the enactment of Staggers, the fact remains that each railroad owns and controls its own right-of-way and no other railroad can compete to provide better rates or service. In the absence of this competition, we believe rail shippers need a regulatory framework that defines rights and remedies for captive shippers. As you know, to obtain rate relief, a captive shipper must first prove his "captivity" by proving the "market dominance" of the railroad. "Market dominance" exists when a shipper has no reasonable alternative to the rail shipment in question, and therefore is subject to railroad monopoly power. The I.C.C. has been so liberal in defining reasonable alternatives that "market dominance" has almost no meaning.

We believe legislation could be introduced directing the I.C.C. to eliminate discriminatory railroad rates between geographic areas of the country and base rail rates on weight, volume and distance on a uniform basis for all regions. We believe the I.C.C. should also be directed to develop a clear, precise definition of "market dominance" and "captive shipper" that recognize the realities of rail transportation. Shippers can seek administrative and judicial protection only with legal standing provided by adequate definitions.

Another area in need of modification is in regard to joint rates and through routes. Grain farmers and shippers need the ability to market their commodities, for both export and domestic purposes, unimpeded by artificial barriers that have been erected by some rail carriers. Under the Staggers Act, artificial barriers in the form of canceled rates for through routes do not provide for increase competition in the transportation marketplace. On the contrary, canceled rates for through routes lessen competition by restricting certain carrier participation in specific markets and by limiting the choice a shipper has in getting his commodity to market.

Agricultural shippers often move their products through two or more railroads and thereby depend upon joint rates to establish the rail rate framework for the national rail transportation system. In many cases, the joint rates determine the ability of shippers to be competitive in markets far removed from the point of origin. The unilateral abandonment of established rates in favor of changeable single-line rates not only creates an unpredictable rate climate for agricultural shippers, but also damages the ability of U.S. agricultural products to compete in highly competitive international markets.

Farm Bureau believes there should be some refinement of the Staggers Act to provide reasonable joint rates and switching agreements in order to promote the efficient transportation of commodities among different rail service areas. We believe reciprocal switching should be available at all locations served by more than one carrier at fees based upon the actual cost of performing the service. Railroads should not be allowed to levy arbitrary switching fees that in effect restrict shippers to the use of specific rail lines.

We believe legislation could be introduced directing the I.C.C. to prohibit railroads from preventing other railroads from competing for traffic by refusing to interchange traffic or refusing to establish competitive rates and charges on through routes and for reciprocal switching charges. In doing so, these railroads have contended that the rates and charges do not cover the costs of providing these services or that they apply to routes that are circuitous or otherwise inefficient. Agricultural shippers contend that these cancellations are anticompetitive.

In the event these directives from the Congress should not prove effective in providing relief for captive shippers, the Congress could consider triple damages to remedy abuses of market power by the railroads in captive shipper situations. If there is some question as to whether the antitrust laws apply to restraints of trade and monopolistic practices of railroads, the Congress could amend the antitrust laws and the Interstate Commerce Act without the necessity of reopening the Staggers Act and reregulating the rail industry.

The Staggers Act has improved the efficiency and reliability of shipping goods by rail. Railroads have once again become financially sound and this has enabled the rail industry to provide improved grain handling service in most areas of the United States, with enhanced port capacities, unit trains and other improvements that are in the best interest of agriculture.

Railroads are posting ample profits, and they have been investing millions of dollars to modernize their systems. The first goal of rail deregulation--a more productive, financially stable system--has been achieved. Although we see some need for modification, we continue to believe the long-term goal of reform should be to keep easing off regulation by making the shipping industry even more competitive.

As mentioned previously, there have been some problems with the implementation of Staggers. We have tried to identify the justifiable concerns of agricultural shippers. One of the benefits of reduced regulation is the ability of railroads and their customers to discuss problems and negotiate settlements without the need to reregulate the railroad industry. Since the enactment of Staggers, the industry has seen the need to reduce its cost structure, followed by rate reductions, while providing substantially improved service in its efforts to remain economically viable. This would not appear to be the time to amend the Staggers Act and attempt to reregulate the rail industry.

Senator ROCKEFELLER. Thank you, Mr. Berg.

Mr. Harding, the railroads said a good deal this morning that the gains that they have made in efficiency have been passed on to the consumers—well, let us say in your case to the farmers and the grain people.

Do you agree with that?

Mr. HARDING. In a marketplace where we have had excess capacity, whether it is transportation capacity or elevator capacity or handling capacity, rates have gone down, whether they are rail rates or our charges for handling grain. And that has really been the driving force of reduced rail rates, not Staggers.

Senator ROCKEFELLER. Well, let me put it this way, then. If the CURE bill were to pass, Consumer Rail Equity bill were to pass, do you think that the shipping rates might further decline on your captive shippers?

Mr. HARDING. Well, I think the hope of the people who are putting that legislation forth is that a realistic cap could be established, especially for coal rates, above which rate levels can be challenged.

Today the problem is you cannot challenge at any level. As long as that cap does not affect the level of grain rates, we would not be opposed to it. But we do need to have economic grain rates to participate in world markets, and we cannot afford to have them go up.

Senator ROCKEFELLER. You are familiar with the McCarty case, of course?

Mr. HARDING. Yes, I am.

Senator ROCKEFELLER. Is it your impression that the railroads will accept the McCarty case decision by the ICC or that they may appeal it?

Mr. HARDING. I think they will appeal it.

Senator ROCKEFELLER. And in fact, it is not even entirely clear at this point, is it, that it is a final decision of the ICC?

Mr. HARDING. It is a very tentative decision. It almost is a no-man island type decision. Nobody knows where they stand.

Senator ROCKEFELLER. So you would not be quite prepared to say that the so-called rate reasonableness test has in it any stability or predictability, even after seven years of waiting?

Mr. HARDING. Absolutely not.

Senator ROCKEFELLER. Mr. Berg, I am a little confused by your testimony, in that you appear not to want to see the CURE legislation passed and you talk a good deal about some satisfaction with where the situation is now. Am I right about that?

Mr. BERG. Yes, that is correct. I did not mention the CURE bill, but we believe the CURE bill is a re-regulatory bill, and we think the Staggers Act has worked very well, Senator, and we see no reason why we should amend the act at this time, at this particular time anyway.

Senator ROCKEFELLER. But does not the Farm Bureau itself have a resolution adopted this year which favors legislation?

Mr. BERG. Well, yes, it does. We favor legislation to refine the captive shipper and the reciprocal switching arrangements, and I thought I addressed that in my statement.

I am thinking more of a sense of Congress resolution directing the ICC.

Senator ROCKEFELLER. Sense of Congress resolutions do not get anything done. I mean, that is the point I am trying to address. I have a copy of your Farm Bureau policies here for 1987.

You do in fact—I mean, the words are: "We shall seek refinements of the Staggers Rail Act to provide reasonable joint rates and switching rules in order to promote the most efficient movement of commodities, et cetera."

Mr. BERG. That is correct.

Senator ROCKEFELLER. Now, you cannot refine the Staggers Act by a joint resolution of Congress or a sense of the Congress, and you cannot do it by asking the ICC. You only refine, you only refine an Act by Congressional action. And this is what you have adopted.

In fact, you have adopted the same thing for the last four years.

Mr. **Berg**. That is correct, we have.

Senator **Rockefeller**. So I am still confused.

Mr. **Berg**. We still believe in our policy. If you will read further, it also says that: "We urge the ICC to continue deregulation of the railroads."

Now, we feel we can do that. I testified a couple of weeks ago before the House and said if the Congress would prod the ICC to take action in that regard, I think they would.

The testimony of Mrs. Gradison this morning said that for the last 18 months they have been making all kinds of changes in the ICC implementation of the Staggers. We have every reason to believe she will continue. But it does need a little prodding by the Congress.

But I do not think we need legislation, Senator, to re-regulate the entire railroad industry. And the CURE bill gets into all kinds of things which we do not think—well, we just have not brought around our support yet.

Senator **Rockefeller**. Well, let me get to that in a moment. And I agree with you that Chairman Gradison said she was doing all kinds of incredible things at the Interstate Commerce Commission.

The question is, are they happening? Now, rate reasonableness, I mean, ultimately things come down to what you have to pay, rates. And in spite of what she said, the fact is that in the seven years since the passage of the Staggers Rail Act there have only been two final rate relief decisions that have been given, and those two are currently under appeal by the railroads.

So you could really add it up to zero.

Mr. **Berg**. I thought she disagreed with you on that.

Senator **Rockefeller**. Yes, she did, but she was quite wrong. And when she referred to the San Antonio case, all the work she was doing was quibbling over arithmetic that was set in the Staggers Act itself in the San Antonio case, which was about a $100 million case, that the rate was set at about 162 percent revenue to variable cost ratio.

And what she was doing was quibbling over arithmetic. She did not know that, but that is what she was doing.

There have only been two cases that have been rate relief cases, period. Now, there is a tentative one, the McCarty case, which is not a decision yet because it is only tentative. And if it becomes a decision it will be, as Mr. Harding indicates and everybody in the railroad certainly indicated, it will be appealed.

So the net effect of all of this seven years is two, one in Omaha and one in Arkansas, for rate reduction. Now, both of those, incidentally, one last year and one this year, were given on the day before a House committee addressing the subject of the Interstate Commerce Commission and its performance was being held.

So my question to you is, what gives you this confidence in prodding the Interstate Commerce Commission, as opposed to addressing problems which you generally have and which your Bureau recognizes, that simply prodding the ICC is going to work?

And I am not trying to badger you. I am really curious.

Mr. **Berg**. Well, that is why we are suggesting something in the form of a sense of Congress resolution that will get their attention. I suggested in my testimony then, if that does not get their attention, then we can introduce legislation for double or triple damages. That will get the railroads' attention.

There are other ways of going about this, I believe, without re-regulating the railroads, because from an agricultural perspective, Senator, we think that the Act has done pretty well.

Senator **Rockefeller**. Now, you understand in the CURE legislation that in no sense do we re-regulate or attempt to change any contracts or anything which comes under the statutory level for revenue to variable cost ratio? In other words, the only thing the CURE bill refers to are those shippers above the line who are captive.

Nothing—85 to 90 percent of all railroad transactions, everything going on in this country, is totally unaffected by the CURE bill. You said re-regulate. We are not re-regulating. We change nothing about that.

Mr. **Berg**. Well, those who oppose the CURE bill think it is a re-regulation bill.

Senator **Rockefeller**. I know they do.

Mr. **Berg**. And this morning two executives of the railroads, two of them said there are no captive shippers on their lines. Two others said ten percent of their shippers are captive. Now, these are executives of the railroads.

I do not doubt their integrity. We have a situation with grain farmers in Montana that has been pretty bad for the past five years. It has been under litigation for over five years.

But I do not see any reason to re-regulate, when 90 percent of the farmers seem to be happy with the Staggers Rail Act.

Senator **Rockefeller**. Well, do you want to respond to that, Mr. Harding?

Mr. **Harding**. Well, I think the problem is that, again, excess transportation capacity has brought about lower rail rates, and not the Staggers Rail Act. And as that capacity dries up, we could see rail rates going back up again, and I think maybe some of those farmers would start to have concerns again about rates.

But our issue is really competitive access, and we think if you force competition in the marketplace, if you force railroads to compete through switching agreements, through joint rates and routes, through terminal access, that you are going to have enough competition in the marketplace to keep the rail rates honest, and that is really what we are pushing for.

Senator **Rockefeller**. Mr. Berg, maybe just one more question. You did write Congressman Tauke on June 10th that the Farm Bureau supported legislation in certain areas? I have the letter.

Mr. **Berg**. That we supported legislation in certain areas?

Senator **Rockefeller**. Yes. Did you not?

Mr. **Berg**. Yes, I did write to Congressman Tauke. Yes, I did.

Senator **Rockefeller**. You favor legislation to give greater rate-making flexibility to rail carriers to permit—I mean, you did suggest some legislation.

Mr. Berg. Yes, I did, the same identical recommendations as I made in my statement to you, to this committee this morning. I believe the same language is there.

Senator Rockefeller. I will also submit your letter to the Representative for the record by reference.

Gentlemen, I do not have any further questions of you. I would observe, Mr. Berg, that the Association of American Railroads has indeed taken out advertisements which have suggested that the CURE legislation is an attempt to re-regulate the railroads.

I do not want you to think that is true. It is not any such thing. And they are saying that and have been consistently saying that, knowing that it is not true. But nevertheless they say it, because they are in a position by saying it and when people believe that they only and always tell the truth, as you appear to, they obviously put the fear of God in a lot of folks.

And that makes it tougher to address these issues of captive shippers. It is my impression that the work that those of us who support the CURE bill are trying to do is to help your people. That is my impression.

Mr. Berg. We think we are trying to help the coal people, because we feel that if the people who are interested in the CURE bill are successful in reducing coal rates, it will up agricultural rates and rates on other merchandise.

Senator Rockefeller. They have already testified that that will not happen.

Mr. Berg. There are 320 very large shippers in this country—Sears, Roebuck, Procter & Gamble, Frito-Lay—the biggest shippers I guess in the country, they are all opposed to the CURE bill. They cannot be wrong. Their legal firms have looked at this up and down for the last three Congresses, the Ninety-Eighth, Ninety-Ninth, the Hundredth Congress.

Senator Rockefeller. Mr. Berg, do you know that Mr. Dempsey sat right almost in your seat and said that they would not be in a position to increase competitive rates if the CURE bill passed, and in fact the scenario you are suggesting, that if coal rates went down that your rates would have to go up, in fact that that is not the case? He said it would not happen.

Mr. Berg. Well, the railroads have as much as said that. I think they have said that, that they are going to have to increase their rates or they are going to go out of business. We either divert to truck or pay higher or, railroads will cease reinvesting resulting in poor service and abandonments.

So either that or they go to truck. And if they go to abandonment or truck, it is going to have a very detrimental impact on local communities, it is going to have an impact on their highways and their roads, inefficient energy use, There will be a tax increase to repair the roads. Pollution problems is also something to think about as well as congestion.

So that is why, we do not think that we are going to support the CURE bill at this particular time.

Senator Rockefeller. Although you will support certain legislation?

Mr. Berg. We hope a sense of Congress resolution will be approved. If agriculture and the other merchandisers do not use the railroads, then coal is going to get an increase. So that is why we are helping the coal industry by opposing the CURE bill.

Senator **Rockefeller**. I am grateful for your support, Mr. Berg. I thank you gentlemen and I declare the hearing adjourned.

[Whereupon, at 2:00 p.m., the subcommittee was adjourned.]

RAIL INDUSTRY/STAGGERS RAIL ACT OVERSIGHT

WEDNESDAY, JUNE 24, 1987

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
SUBCOMMITTEE ON SURFACE TRANSPORTATION,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room SR-253, Russell Senate Office Building, the Hon. J. James Exon (chairman of the subcommittee) presiding.

OPENING STATEMENT BY SENATOR EXON

Senator EXON. The subcommittee will please come to order. This morning the Surface Transportation Subcommittee's series of three hearings on the rail industry are going to come to a close.

As the subcommittee chairman, I think this series of hearings has helped the subcommittee develop a record of important issues regarding the financial well-being of the rail industry and the ICC's implementation of the Staggers Act.

We have heard from the industry, shippers and rail workers.

All of these have made their case in appearances before this subcommittee as to whether the system is working, and whether or not improvements are needed.

As a Senator representing Nebraska, I found the statistics on decreased railroad rates for grain especially interesting. At least my state seems to have benefited from the Staggers Act, and this indicates that the Staggers Act has some good results for grain shippers and farmers, though I am eager to hear from Senator Melcher this morning and others that want to outline the experience that their states have had.

Today our series of hearings concludes with testimony on legislative proposals affecting the rail industry and the Staggers Act. Specifically, we will receive testimony on S. 676, the Consumer Rail Equity Act.

This bill is sponsored by my colleague from West Virginia, Senator Rockefeller, who has introduced this measure to correct what he feels are abuses in the ICC's treatment of captive and other shippers.

This hearing will provide us with the opportunity to carefully review the bill, to determine how it would address the problems identified by some shippers and what its effect would be on the industry and the Staggers Act.

I would like to conclude by noting that I scheduled this series of hearings because I felt it was time to try to develop a record, and perhaps a consensus on the problems facing the industry, shippers and rail workers.

Whether a consensus can be developed on these issues remains to be seen. I am hopeful, however, that in pursuing this goal it will be in continued recognition of the balance that was intended to be drawn when the Staggers Act was adopted by the Congress. And that is that we want a strong rail system, and we want to encourage competition, jobs for railroad workers and protection for those shippers who are otherwise subject to railroad market power.

With these remarks, I would like to call on my colleagues for any remarks that they wish to make at this time before I call the first witnesses. I will call first on the ranking Republican Member of the committee, Senator Kasten. Senator Kasten?

OPENING STATEMENT BY SENATOR KASTEN

Senator KASTEN. Mr. Chairman, thank you, and first of all I would like to congratulate you on this informative series of hearings.

I think that we have provided the subcommittee with the background that the subcommittee needs to make some of the important policy judgments on the future of the railroad industry, and for this series of hearings, I congratulate you.

The question before the subcommittee today is whether we need the CURE bill or whether the Staggers Act is working sufficiently well that any changes could best be accomplished by administrative fine tuning.

Proponents of the CURE bill argue that the Interstate Commerce Commission has misapplied Staggers. They argue that Staggers must be amended to balance the interests of shippers, particularly captive shippers, and the railroads.

CURE says it does not want to rewrite the Staggers Act, but rather fine tune the way in which the ICC administers the Act. The opponents, on the other hand, which include the railroads and some shipper groups, characterize it as a substantial reregulation.

They argue that the bill's provisions will substantially complicate rate proceedings and shift the burden of proof in those proceedings, will greatly increase the number of competitive access proceedings, and increase state regulation of railroads.

CURE's opponents argue that the bill will result in inadequate rail earnings, rapid disinvestment in rail facilities, and lastly the deterioration of rail service.

The ICC also opposes the CURE bill. It cites its record over the last 18 months as evidence that the CURE amendments are unnecessary. That record, which was put forward forcefully by Chairman Gradison at last week's hearing, includes a number of particular points, the development of coal rate guidelines, several major coal rate decisions, the reduction of its rate docket from 50 to 23 cases, proposed small shipper guidelines, and new competitive access rules.

The ICC says the CURE bill will substantially reregulate the rail industry. I was impressed when she said that the bill would change their position in a sense from a backstop into an umpire that must call every pitch.

Mr. Chairman, I look forward to a healthy debate on the CURE bill today, from today's witnesses. But mostly I congratulate you, commend you for this broad-based approach to this overall question.

Senator EXON. Senator Kasten, thank you very much. I am now pleased to call upon my friend and colleague from West Virginia, the author of the CURE bill, S. 676, without whose tenacity in pursuing this issue, which needs a thorough review by the subcommittee, we would not be here this morning. Senator Rockefeller?

OPENING STATEMENT BY SENATOR ROCKEFELLER

Senator ROCKEFELLER. Let me think that over.

Mr. Chairman, obviously I join with Senator Kasten in thanking you for this comprehensive series of hearings. And I think we have in fact built a very substantial record.

Often questions that take place during these hearings are not so much intended for just dramatic effect, although sometimes dramatic effects may arise. But they are done to lay down a foundation upon which the debate and the merits of a bill, or a potential change, can later be argued.

Mr. Chairman, during the first two days of these hearings, the problems of the ICC's implementation and interpretation of the Staggers Rail Act have, in my judgment, been very well established. Today we focus on the remedy which, to me, is the Consumer Rail Equity Act.

Many of the promises of the Staggers Rail Act have been fulfilled, as the ranking Member has pointed out. The financial picture for the railroads of health, rather than despair, an ability to rely on the marketplace for contract rates, an ability to establish rate, service and routing options free of regulatory lag and bureaucracy. I do not doubt for a moment that to many shippers, the Act is considered a resounding success.

For some, however, the promises of the Staggers Rail Act have been elusive and unfulfilled. Many bulk commodity shippers, particularly Appalachian coal shippers, have been shackled by the so-called freedom of the marketplace, paying excessively high rates and, frankly, losing business.

Likewise, shipper complaints have been frustrated by the patently ridiculous interpretations of the Interstate Commerce Commission, not the least of which is that after seven long years of enactment, no clear and predictable test of rate reasonableness exists, no matter what the Chairperson says.

Mr. Chairman, the English political theorist Edmund Burke once wrote, "produce nothing wholly new and retain nothing wholly obsolete." In large measure, that is the goal of the Consumer Rail Equity Act, to make a mid-course correction in the implementation of the Staggers Rail Act.

The bill does not seek a return to justifiably discredited regulatory schemes that the Staggers Act eliminated. But it does propose to do away with the regulatory interpretation that stands in the way of equitable and fair railroad rates for coal shippers, yes, for grain shippers, for bulk product shippers. In short, for shippers who today pay too much.

The Consumer Rail Equity Act would modify the existing situation in five key areas. It would require the ICC to adopt standards that would provide an accurate assessment of a railroad's financial health.

S. 676 would also require the ICC to adopt a consistent and predictable test of rate reasonableness that includes some consideration of a railroad's actual cost of service.

In addition, Mr. Chairman, my bill would require the ICC to accurately measure the efficiency and the productivity improvements of our nation's railroads, and would reaffirm the Commission's obligation to protect and promote rail to rail competition.

The Consumer Rail Equity Act would make necessary procedural, but not substantive changes in such areas as abandonments and state regulations of intra-state rates.

Mr. Chairman, my bill is fair and my bill is balanced. It does not reregulate the railroads. It does not affect the right and the ability to enter into contracts. It does not repeal the statutory threshold nor the concept of differential pricing. All of those are left exactly intact as they are in the Staggers Rail Act of 1980. In short, it protects the cornerstones of the Staggers Rail Act.

Mr. Chairman, we must act to restore equity to this complex regulatory process. I am committed to a fair resolution for all those concerned, as I know the Chairman is.

I also look forward to today's hearing and to an early, hopefully early markup of the Consumer Rail Equity Act. I thank the Chair.

Senator EXON. Thank you very much, Senator Rockefeller.

Senator Danforth.

OPENING STATEMENT BY SENATOR DANFORTH

Senator DANFORTH. Thank you, Mr. Chairman. Today, we turn to the Consumer Rail Equity Act, which is sometimes known as the CURE bill. This legislation would substantially revise the Staggers Act and result in significant re-regulation of the railroads. The question that must be asked in whether such reworking is necessary. I think the answer to this question is apparent if one examines the record of the Subcommittee's hearings from the past few weeks.

First, the record indicates that Staggers is working well. The railroads, while far from robust, have recovered from the near collapse that occurred in the late 1970's. The railroads' recovery has not come on the backs of shippers. On the contrary, railroads have increased their productivity and, in constant dollar terms, have lowered their rates to shippers.

Another encouraging development is that in the last 18 months, the ICC appears to have snapped out of its lethargy. The Commission has developed workable coal rate guidelines. It has decided a number of major coal rate cases by making large awards to several utilities and a municipality. The ICC has also proposed new guidelines designed to help small shippers bring rate cases. Its rate case docket has dropped from 50 cases to 23 cases. The ICC has also adopted new rules on competitive access which are a reflection of a railroad-shipper agreement.

The Commission's response has been encouraging. At the same time, it is important for this Committee to continue to monitor the ICC, especially with respect to how it applies its revised regulations to individual cases. While this oversight is important, I do not support amendments to the Staggers Act. Legislation that has worked so well should not be amended. Fine tuning is best accomplished at an administrative level. Certainly, the substantial re-regulation that has been proposed by CURE is not necessary.

Mr. Chairman, I look forward to our witnesses' testimony on this important issue.

Senator EXON. I am pleased now to call upon our first witnesses this morning, Senator Melcher from Montana, and Representative Rick Boucher from the State of Virginia.

We will proceed first with Senator Melcher. Senator Melcher, welcome.

STATEMENT OF HON. JOHN MELCHER, U.S. SENATOR FROM MONTANA

Senator MELCHER. Thank you very much, Mr. Chairman. And thank you for having the hearings and thank you and your colleagues on the subcommittee for allowing me to testify.

My predecessor, Mike Mansfield, in the early 1970s, said out of frustration, or announced out of frustration on one occasion that if the Interstate Commerce Commission could not become more effective and have some purpose in life, he would introduce a bill to abolish it.

The bill was never introduced. The Commission, of course, is not abolished. But under the Staggers Act, apparently, the opportunity for delay in making a decision has been enhanced.

I want to tell you about one such instance, and I think you will have to agree with me that something needs to be done legislatively to make it possible for a group of shippers with a good cause to come to the Commission and get a decision.

First of all, you have to understand that in Montana, we are, in some instances, very much of a captive state. We are a producing state. Coal, oil and gas, forest products, agriculture and minerals.

The coal moves by unit train, in most instances, and the utility companies bargain with the carrier, the Burlington Northern, and they seem to get a rate that satisfies them. I will not go into that.

The forest products people can, in some instances, move by truck, and do. So there is, I believe, some form of competition between truck and rail, for the movement of forest products.

Now, oil and gas is going to move by pipeline. So, what we are really captive of in Montana is on grain. We have no barge service, trucks could not possibly or conceivably carry anything but a fraction of it each year.

And I will not dwell on minerals. They are not coming to me and telling me they are being abused. I want to tell you about the grain shippers, because this case is probably a classic case, in that the shippers pursued it over a number of years, before they got a determination.

It is called *McCarty Farms* v. *Burlington Northern*. The docket number is 37809. It started in September of 1980. That is almost seven years ago. It has not been completely cleared up yet, but let me describe the case.

A group of wheat and barley farmers from around Plentywood and Big Sandy and Hogeland and Chester and Reserve, all in northern Montana, filed a class action suit against the Burlington Northern in the U.S. District Court in Great Falls.

They challenged the rates charged for the transportation of wheat in Montana to Portland, Oregon. The District Court referred the case to the ICC, as the proper forum. In December of 1981, an ICC administrative law judge decided in favor of the farmers.

So that went fairly fast. It started in September of 1980 in District Court, was thrown into the ICC, and the administrative law judge in December 1981, a year and three or four months after they started, ruled in favor of the farmers.

He found the revenue to variable cost ratio charged for these shipments to be 300 percent, and ordered the rates reduced to a maximum revenue to variable cost ratio of 200 percent.

The BN appealed the market dominance portion of the decision, and the farmers' expensive ordeal was just beginning. During the course of this proceeding, the Commission consistently frustrated the farmers' case by requiring submission of new evidence every time the Commission considered a new rate reasonableness or market dominance test.

At times the ICC reopened the case and sought evidence or comments on unregulated or ill-defined issues, making it impossible for the farmers to determine what kind of evidence the Commission would consider relevant to deciding the outcome of the farmers' rate challenge.

Other procedural steps were taken, like splitting the case into two parts to consider wheat and barley rates separately. Halfway through this case, the farmers ran out of money, after spending about $400,000.

And Mr. Chairman, I want to pause right there. This is a group of farmers, from those communities that I earlier mentioned, which I imagine none of you have had the pleasure of visiting.

I get around there every now and then. These are farmers, and there are relatively few of them. But small groups of farmers raised $400,000.

Halfway through this case, the farmers, of course, ran out of money.

The Montana Legislature then said, well, we are going to help. This is vital to the state. So they brought out a $300,000 appropriation. And that permitted the state to join the farmer group and keep this case alive.

The state subsequently, in 1985, appropriated an additional $144,000. The law firm handling the case for the complainants has swallowed $260,000 in legal fees and expenses.

All right, I am going to go over that. The $400,000 was all farmers' money to begin with. That went on for a couple years. They got so far, and had the backing of the administrative law judge that said, indeed, this is not right. These rates have to be reduced.

But to get a final determination on the appeal by the Burlington Northern before the ICC, the state had to come in with another $300,000, and then another $144,000. That is big money in the state legislature of Montana.

But in order to get by, the law firm had to just write off $260,000 in legal fees and expenses. Well, we are up to $1 million, now, counting everybody that came in.

Our breakthrough in this case occurred December, 1986, over six years after it started. That is when the ICC moved to disallow submission of further evidence on market dominance, and pledged to move expeditiously to a decision on this jurisdictional threshold issue.

On May 27 of this year, the Commission, on a unanimous vote, told us what we have known all along. The State of Montana is captive to the Burlington Northern. In a surprise move, the Commission also tentatively found the rates being charged as unreasonable, using a non-coal commodity rate reasonableness standard still not approved in its final form.

Now, if the ICC does not decide to upset the cart again, we should have a final decision on this case by early fall. The ICC is an ever changing bizarre world in which, by design or ineptitude, or because of requirements of the Staggers Act, parties seeking redress for legitimate rate grievances are continually frustrated. There is a disturbing appearance of insensitivity to the plight of captive shippers on the part of the majority of Commissioners. This attitude is exemplified by the comments made to Montana grain shippers last July by Chairman Gradison when she indicated the Commission did not want to decide the case and admonished the grain shippers to negotiate a settlement with the BN. In a statement that raised the ire of many of my fellow Montana citizens who know quite a bit more about the BN than the chairman apparently does, Mrs. Gradison said that Montana shippers "are lucky to be captive to somebody who's honorable and knowledgeable and willing to negotiate." I have a copy of the press article quoting Chairman Gradison and ask that it be made a part of the record at this time.

There is a disturbing appearance of insensitivity to the plight of captive shippers on the part of the majority of the Commissioners. After six and a half years and expense of over $1 million, can anyone say that the farmers of Montana have received adjudication in this process?

Has the ICC been reasonable and prompt in saying to the Burlington Northern, enough is enough, you can not continually stall this. I find this record of the ICC personally deplorable, and it is discouraging.

But it was a victory. It will be a victory, if we get the final determination. We are going to continue to press, as was the idea when this case was started, to get that final determination.

But Mr. Chairman, when a group of farmers have to wait almost seven years to get a decision, that is not satisfactory. That cannot be satisfactory to us. We understand their plight. They truly are captive.

The procedures that they had to go through at the first stage was not too long. After all, the administrative law judge made the decision, said the obvious. These rates are too high. Get them down. And the law says you must bring them down.

Mr. Chairman, after over six and a half years at an expense of over one million dollars, can anyone say that the farmers of Montana have received fair adjudication at the ICC? Not only have they been paying for lawyers and expert witnesses, but these farmers are still being charged rates in the 240-250 percent of variable cost range. I find the ICC's record of administrative obfuscation personally deplorable and my constituents despite the promise of victory, are understandably outraged.

The State of Montana and the Montana Congressional Delegation are dedicated to seeking a final resolution of this case. I hope the Committee will address the *McCarty Farms* case in these hearings and seek from the ICC what I have been unable to obtain—an adequate answer to why this case took so long before they reached the tentative decision of May 27. There is a suspicious coincidence surrounding this recent decision. One could easily conclude that the ICC acted when the political heat was firing up in an attempt to cool the fury of this body over their record of inactive. We are happy with the decision, however tentative it may be, and only hope that other farmers across the country do not fall into the abyss like we did. It can be frustrating, costly and defeating. With a history like *McCarty Farms,* it is little wonder there are so few rate challenges at the Commission.

But the procedure then for almost six years of allowing it to be wrapped around and around in the bureaucracy of the Interstate Commerce Commission is not good law. We owe it to the people of this country to correct this situation. And the power to do it starts right here in this subcommittee.

Mr. Chariman, in closing, I ask that the Committee make a part of its record correspondance I have received from the Montana Grain Growers Association that outlines the history of this case. I appreciate your indulgence and that of the Committee on this matter of considerable importance to the State of Montana.

I hope you exert that power in the public interest, and to make right out of wrong. Thank you, Mr. Chairman.

Senator Exon. Senator Melcher, thank you very much. And as usual, you have made your case and the case for American farmers, on whose behalf you and I have worked together, shoulder to shoulder, for a long, long time. And I appreciate very much your helpful testimony in front of the subcommittee.

Representative Boucher, we are pleased to have you come over from the House this morning to give us your view on this. I know that you are the principal sponsor for the CURE bill on the House side.

I am looking forward to your testimony. I assume that it will be along the same lines as that of Senator Melcher, protecting the extensive wheat interests of the State of Virginia.

We are glad to have you.

STATEMENT OF HON. RICK BOUCHER, U.S. REPRESENTATIVE FROM VIRGINIA

Mr. BOUCHER. Thank you very much, Mr. Chairman. I appreciate this opportunity to appear before your subcommittee today to testify in support of the Consumer Rail Equity Act.

That is the House version of the very same bill that is pending before this subcommittee, authored by my friend from West Virginia, Senator Rockefeller. The House transportation subcommittee has now completed three days of hearings on the Consumer Rail Equity Act.

We received testimony from the ICC, from the Federal Railway Administrator, from the railroads, and from a very large variety of shippers, both large and small. On the whole, that testimony was not surprising.

The chairman of the ICC told the subcommittee that all is well, that all that is needed to set the record straight is just a little more time. Mr. Riley of the FRA told the subcommittee that the railroads today linger in a precarious financial condition, one that justifies the continued excessive rates that are being imposed upon captive shippers.

We heard from some of the most profitable railroads in the country that rates well in excess of the ICC's jurisdictional threshold are justifiable, and astonishingly, at least from the standpoint of this Member, that in the opinion of the railroads there are no captive shippers.

And we heard the pleas of captive shippers themselves for some rational relief from rail rates which threaten their ability to compete in both national and international markets.

Even the most callous observer, Mr. Chairman, would have to conclude that something is wrong when it takes the ICC six years to find that a railroad which controls 98 percent of the grain exports from the State of Montana, as Senator Melcher has pointed out this morning, is market dominant. When it takes the ICC that length of time, obviously something is amiss in those procedures.

When the chairman of the ICC tells the Congress that, notwithstanding the use of revenue adequacy determinations that are made by the ICC on an annual basis as a fundamental part of the formulas for deciding whether or not rates imposed upon captive shippers are fair, that the determination of revenue adequacy is absolutely immaterial. That was the testimony we received.

When financial analysts who appear to paint a bleak picture of the railroads' financial health are simultaneously advising their clients to invest in railroad stock. And when utilities in this country can ship coal from South America at a lower cost than coal from middle America, Mr. Chairman, something is clearly wrong.

There is general agreement, as Senator Rockefeller said, that the Staggers Act of 1980 has worked well, that it has strengthened the financially unsound rail industry, that it has made that rail industry leaner, more productive, and highly profitable.

But the subcommittee also learned that the success of the Staggers Rail Act in promoting competition and a healthy rail economy has been overshadowed by the failure of the ICC to implement the captive shipper protections that are also a feature of the Staggers Act. And that is a failure that has caused enormous damage.

For example, unreasonably high rail rates are pricing American coal out of the world market and American coal miners out of their jobs. In some states, high rail rates have made American coal uncompetitive domestically with other forms of energy, and even with imported coal.

That is the burden that our domestic coal operators are being asked to bear as a result of monopoly control over their transportation routes and regulatory indifference by the ICC.

The Consumer Rail Equity Act neither expands the regulatory umbrella of the ICC, nor undermines in any way the foundation of deregulation that was laid by the Staggers Rail Act of 1980.

Eighty-five percent of all rail traffic today exists in a competitive market. Our legislation would do nothing to subject that traffic to regulation. It does, however, ensure that the ICC gives meaning to the Staggers Act requirements that shippers who have no alternative to a single railroad receive protection from price gouging.

I am pleased to report that my colleague Tom Luken, the chairman of the House transportation subcommittee, has initiated discussions in an attempt to resolve the very significant problems that face captive shippers today.

It is anticipated that these discussions, involving all the interested parties, will commence in earnest by the end of this week. Let me take this opportunity to implore the participants to engage in good faith negotiations with an eye toward addressing the very legitimate concerns that captive shippers have presented.

But let me also caution those who may be somewhat reluctant participants that our legislative efforts to reform the Staggers Act will move forward if the negotiations are not successful.

The chairman of the House Energy and Commerce Committee has noted that a negotiated solution is far preferable to one that is imposed by Congress, but he said, and I quote, "one way or another, the Committee and the Congress must act."

Mr. Chairman, let me conclude by thanking you for this opportunity to appear today, and by urging you and the other subcommittee Members to join in this effort to enact needed responsible reforms to the Staggers Act, reforms that will fulfill the commitment Congress made to captive shippers in 1980 to protect them from the excesses of monopolies.

I appreciate the opportunity to appear here today in support of Senator Rockefeller's bill, and I will be happy to respond to your questions.

Senator EXON. Congressman Boucher, thank you very much. Let me ask you both this general question.

Had the ICC, in your opinion, taken the actions that they could have taken under the authority given them by the Staggers Act for appropriate relief for the constituents that you both so ably represent, would there be a necessity for the CURE bill?

Senator MELCHER. Mr. Chairman, I believe the Staggers Act allows the ICC so much latitude in putting off a decision-making process that it is no longer effective on this point of captive shippers.

I am not trying to tell this committee what type of legislation is necessary. But I am here to tell you, something is necessary. Because what has happened to us in Montana is a clear cut case of insufficient law to bring results to a conclusion.

There never was any doubt from the start of the case that the McCarty group of farmers in Montana were correct. There was market dominance and the rates were too high. The ICC has followed the Staggers Act, I believe.

But in doing so that allows for a type of procedure that is unending, and there are very few shippers who have been damaged that will stick with it that long and spend that amount of money.

Therefore, I think the Staggers Act needs to be amended and strengthened in this area to protect the shippers.

Senator EXON. Thank you, Senator Melcher. I think I agree and understand your response to the question.

But the question was, in your view, had the ICC acted properly, as you and I seem to believe the Staggers Act provided for, would this CURE bill be necessary?

Senator MELCHER. I believe that the ICC acted properly within the latitudes that the Staggers Act allows. And that it is that latitude that must be changed by law.

Senator EXON. In other words, what you are saying is that you think that the ICC has faithfully carried out the intent of the Congress and that they simply do not have enough latitude under the present Act?

Senator MELCHER. No. I think they have too much latitude?

Senator EXON. They have too much latitude?

Senator MELCHER. I think the ICC has too much latitude, and I think the ICC, I will be fair to them, I think that Congress intended to give the ICC too much latitude in the Staggers Act, and it should be narrowed down now on this question of shippers who are obviously captive of a market-dominated carrier. I mean, a carrier who has market dominance.

Senator EXON. You do not think that the Congress was unaware of the captive shipper problem when the Act was passed.

Senator MELCHER. No. We were not unaware of the captive shipper problem. We were lulled into a sense of security that surely the language that we put together was not as broad as it is. And it is too broad. That is my determination. I think it ought to be narrower.

Senator EXON. Congressman Boucher?

Mr. BOUCHER. Mr. Chairman, I think that Senator Melcher is correct.

The ICC has authority to act within the Staggers Act to protect captive shippers. Congress was aware of the problem at the time that the legislation was adopted and tried to expressly provide those protections.

But the ICC, within the bounds of the statute, also has ample authority not to act. And it is the authority not to act that the ICC seems to have exercised.

All that we are asking for in the CURE legislation is to ensure that the ICC exercises the authorities already provided in the Act to ensure that captive shippers are protected.

We are not seeking to reregulate the rail industry in any way. Our bill is needed to ensure that adequate protections are given, that captive shippers have a forum to which they can turn and seek some available relief.

Senator **Exon**. Congressman Boucher, I have heard that because of the cost of coal from foreign sources that is doing great damage to our very important coal industry in the United States, because of the low cost of that coal for whatever reason, that even if most American coal were shipped free to ports, that we still would not be competitive in the international marketplace on coal.

Or, to put in another way, even if we gave free railroad transportation to coal to our ports, it would still not be competitive overseas. What is your answer to that statement?

Mr. **Boucher**. Let me answer that question in several respects. First of all, when I talk to my coal constituents about the single thing that we can do to help expand the coal market, what they repeatedly say is do something about the high rail rates that are being charged by the railroads that enjoy a monopoly.

They have been told that, indeed, our Congressional delegation has been told by foreign buyers of American coal, primarily the Japanese, that the single thing that we can do to make our coal more competitive in the world market is to reduce the rail rates that are being charged domestically.

They have said that our rail rates here are the highest in the world. And I have no reason to doubt that.

Even if our coal is only marginally competitive on the world market because of lower production costs in other countries, we have some other advantages that work for us.

First of all, we have a relatively assured source of supply. Our labor interruptions are short-lived and rather predictable, in contrast to those in other countries. We also have a very high quality of product to sell.

In southwest Virginia we boast some of the best coal that is produced anywhere in the world. It is low sulfur coal, and it is high quality metallurgical coal. And it is much in demand in the world market. We simply have got to reduce the rail rates. That is the key. If we can do it, we can be competitive again.

Senator **Exon**. Thank you. Senator Kasten?

Senator **Kasten**. Mr. Chairman, I have no questions at this time.

Senator **Exon**. Senator Rockefeller?

Senator **Rockefeller**. Thank you, Mr. Chairman. Congressman Boucher, just following up on your point. It is approximately $16 to ship a ton of coal from our part of the world to port.

There has been nothing that I have heard over the last several years, both in this body and when I was serving as governor of West Virginia, which has been more adamant on the part of foreign purchasers, the Japanese and others, as you indicated, and what they have said is that we have to reduce the cost of shipping coal.

It is the railroads. They keep telling us that. They have told us that for years. It used to be they said that we had to get our labor situation, our management situation in order. But that has now been taken care of. There is peace in the coalfields.

There was no strike at all in 1984, and they say, it is the rail rates you have got to get down. The Japanese tell us that. They say, we are going to get Australian coal. They have been going to Australian coal because our rail rates are too high. They tell us that.

The French tell us that. The Italians tell us that. They all tell us that. And we do not do anything about it. If I could just ask you a question or two.

You are served a lot in your part of the country by Norfolk Southern. Norfolk Southern's chairman was here the other day, as he was before your body, and said that fundamentally they do not have captive shippers. In fact, he said, we are captive as railroads to our shippers.

Do you and your constituents see it that way?

Mr. **Boucher**. I was astounded to hear that statement. He made that exact statement before the House subcommittee on transportation.

Eighty-five percent of Virginia's mines are captive to a single railroad, and in fact it is the Norfolk Southern. To understand what captivity is all that you really would have to do is look at the railroad map. There is one color serving southwest Virginia. And that color is Norfolk Southern's color.

Our coal operators certainly know what captivity means, because as I indicated before, they tell us that the single thing Congress could do that would help the most to create an expanded market for the sale of coal and more jobs for our Appalachian area coal miners is to reduce the rail rates that they as captive shippers are having to pay.

I would very much like to have some of the executives from Norfolk Southern come and visit those coal operators personally, and hear from them the problems that they are experiencing as a result of their captivity.

Our legislation is designed to provide the relief they badly need, and I very much hope that, with your concerted efforts here, that bill will move forward.

Senator **Rockefeller**. The railroads made about $1.4 billion last year in profits. According to your understanding, about how much of those profits came from captive shippers?

Mr. **Boucher**. I am told that all of that came from captive shippers. The railroads in their own testimony have said that if all of the rates for the cargo that they carry were reduced to 180 percent revenue to variable cost ratio that not only would they lose all of their profit, but in fact they would be $77 million, as a group, in the hole.

So it is clear that 180 percent being the ICC's threshold for determining captivity, that if you reduced all the rates down to that level, the railroads would be in a loss situation. All of their profits today, that $1.4 billion, are clearly deriving from captive shippers.

Senator **Rockefeller**. Now, Mr. Dempsey is going to testify again this morning. And he more or less agreed with you the last time.

I think he feels a little bit badly about having said that, and is going to attempt to change his testimony this morning. I am not sure that he is going to be able to get away with it. But it will be interesting.

Congressman, is it your intention through this act to reregulate the railroads?

Mr. **Boucher**. Absolutely not. Our legislation would leave totally unaffected the 85 percent of rail traffic that exists today in a competitive rail market.

We believe in the principle of contracts being entered into freely, and without any regulatory oversight. Those contracts would be totally unaffected. We have accepted the principle of differential pricing.

Senator **Rockefeller**. It is not your intention to take away the competitive contracts of the differential pricing concept of the Staggers Rail Act?

Mr. **Boucher**. That is correct. It would not affect the competitive contracts at all. We have accepted the principle of differential pricing.

We just do not think the differences ought to be as great as they are in practice today.

Senator **Rockefeller**. There was a coal miner from, in fact, Virginia who does business in West Virginia here last week.

And he indicated that, because railroads had been unwilling, he could not get them to return his phone calls, in this case I guess the railroad was Norfolk Southern, and he was unable to negotiate the price down. The price of his coal had gone way, way down, 40 percent. But he could not get any help from the railroads.

But he was losing business and it was going to be probably lost to Australia. In other words, France, Egypt, other countries that he was selling to now, the loss of business to them was not going to be picked up by other American companies, or other Appalachian coal companies. That coal would go to Australia.

They would be the ones who would make the money. We would lose the business. They would make the money. Is that the way you see it, in your part of the country too?

Mr. **Boucher**. We are seeing that happen already. As a consequence of the high rail rates, we have already lost much of our export market to other countries.

We are seeing that business being exported abroad. And that is truly unfortunate for those who make their living in the coal industry in southwest Virginia and in West Virginia.

Unemployment in our coal-producing counties today is in excess of 30 percent. That is a tragedy. Something has to be done. Here is an opportunity, in my opinion, for Congress to do something constructive that would not disallow a reasonable profit for the rail industry, but that would put the coal industry back in business.

Senator **Rockefeller**. Mr. Chairman, since Senator Melcher is just literally at the door, could I just point out to him that I wish him well on that McCarty case, and that I bleed for those farmers that put up the $400,000 and the legislature that put up the $200,000 to $300,000.

There is going to be more. That case is not final yet by the Interstate Commerce Commission. They may or may not make it final. They have called it tentative.

If they do make it final, I am not a rich man, but I am willing to bet you that the railroads will appeal it, and if the railroads appeal it, I am not at all unwilling to suggest that they may win it.

And I am suggesting to you that it may be two or three more years yet before your farmers know if they are going to get a reasonable rate or not out of that particular case.

That was unfair of me, Mr. Chairman, because my time has run out, and the Senator was caught standing on both of his two feet. But I thought I might mention that the agony of the farmers in Montana will continue for several more years, I can almost guarantee you, before they understand what kind of a rate they are going to have.

Senator MELCHER. Well, Senator Rockefeller, we are not asking for any out-of-state money in this case.

But we are certainly imploring you to follow your inclination to do something for the public good and the public service of all the country by revising Staggers. Thank you very much.

Senator EXON. Senator Melcher and Congressman Boucher, thank you very much for your interesting testimony. You are excused.

I will now call on John Riley, the administrator of the Federal Railroad Administration. Mr. Riley, would you please come forward.

Mr. Riley, we welcome you back before the committee once again. If you would please proceed with your testimony at this time, and for the record we would appreciate your introducing the associates that you have brought with you this morning.

STATEMENT OF HON. JOHN RILEY, ADMINISTRATOR, FEDERAL RAILROAD ADMINISTRATION, ACCOMPANIED BY MARK LINDSAY, CHIEF COUNSEL; AND JANE BOCKNER, SENIOR ECONOMIST

Mr. RILEY. Before I begin then, let me do that. On my right, Mark Lindsay, who is FRA's chief counsel. On my left, Jane Bockner, a senior economist at FRA.

I am pleased to have them both with me. And crouching down below the edge of the counter there is Tom Simpson, who works in our public affairs office, who is taking the Vanna role today. Thank you, Tom.

Mr. Chairman, about eight years ago, the fifth Federal Railroad administrator, my predecessor, Jack Sullivan, came before this committee to argue for the deregulation of the railroad industry. And it was the first Congressional hearing that I actually saw when I came down here as a staff member.

Jack was a Democrat, and I am a Republican. And we represent two very different administrations. But on this issue we took an identical position. And because this committee shared that view, the railroad industry is a very different place today than it was when we came here eight years ago.

And the difference between then and now is the ultimate test of the success of the Staggers Act. When this committee debated the Staggers Act in 1980, one quarter of the nation's trackage was in bankruptcy reorganization.

Forty-eight thousand miles were under slow order because of their deterioration. We had lost nine major carriers in the relative prosperity of the 1970's. The industry was literally on its knees, and the choices before this committee were nationalization or deregulation.

Now, there were not any winners under the system of regulation that this committee changed, because the problems afflicting the railroads touched every shipper, every community, and every employee who depended on rail service.

Poor cash flows mean deferred maintenance, which translated into derailments, slow turnaround times, and generally unreliable service.

But while all shippers were affected by these conditions, I am convinced from my own experience that rural shippers were unquestionably the hardest hit. Because when the railroads became cash poor, they did exactly what any businessman with a cash crunch would do.

They put their resources into the heaviest density main lines, which gave them their best rate of return, and they left the light density lines to starve.

What that touched off was a 20 year cycle of deterioration that has taken an irreparable toll on America's rural rail infrastructure. And there is no question that overregulation lay at the heart of that.

Now the contrast between then and now is the best argument for the wisdom of the decisions made in this room eight years ago. You can measure the success of the Staggers Act in the revival of the railroad industry.

Today's railroad industry is financially stable for the first time in nearly three decades. It survived the deepest recession since the 1930s without losing a single class one carrier.

But there is an important distinction between stability and financial strength. As the chart on my right illustrates, for all of their improvement in financial performance, and you can see it is substantial since the pre-Staggers era, the railroad industry remains among the least profitable American industries.

Its ROI for the last 12 months was 3.95 percent, and I think that is a revealing figure, because it tells both sides of the story. Because 3.9 percent is real improvement for this industry, far in excess of what it produced in the last decade.

But at the same time, I do not think that anybody other than a railroad or a farmer or a coal miner would go into unrestrained ecstasy over a 3.9 percent rate of return. You could do better than that putting your money in a passbook savings account.

The point is a simple one. The industry's recovery is real, but it is fragile. And it would not take a lot of fine tuning to erode it.

Now, you can also measure the success of the Staggers Act in the pricing benefits it has delivered to shippers and consumers. And shippers and consumers have benefited substantially from the price compression that has taken place in a deregulated surface environment with deregulated railroads competing with deregulated trucks and a barge industry that has never really been regulated.

As the data on my right illustrates, railroad prices in the face of that compression have moderated substantially in every major commodity group since the Staggers Act became law.

The key thing to note about this is that while average prices generally rose faster than inflation in the pre-Staggers era, they have failed to keep pace with inflation, and in many cases declined even in current dollars since the onset of deregulation.

This pattern tracks across all commodity groups, including coal and grain, where many of the captive shippers are found. And I do believe there are captive shippers. I do not share the view that there are not.

Average coal rates have declined in constant dollars, 5.9 percent since Staggers. And that does not take into account contract rates. Average grain rates are down an incredible 44 percent in constant dollars, 28 percent in current dollars. The bottom line is simple. Railroad prices have moderated, not increased, since the passage of the Staggers Act.

You can also measure the success of the Staggers Act in the increased efficiency of America's railroads. Today's industry serves about the same market share we served in 1980, but with 300,000 fewer freight cars, 20 percent fewer locomotives.

And make no mistake about it. These are positive developments. These are changes that should have taken place decades ago, had the regulatory system not constrained the railroads' ability to change their physical plant to adapt to circumstances around them.

And this is a consumer issue, because it is the shipper and the consumer that paid the bill for these inefficiencies. Deregulation has forced the railroads, often against their own tradition, to reduce costs and to pursue operating efficiencies in order to compete effectively. And this process has enabled the railroad to regain economic stability at the same time that they have moderated their prices.

You can also measure the success of deregulation in the rebuilding of the country's rail infrastructure, as railroads utilized the cash flows from deregulation to rebuild their physical plant.

Average annual investment in roadbed and structures has more than doubled since the adoption of the Staggers Act in 1980. And $32 billion has been put back into the nation's rail system.

Deregulation has essentially eliminated deferred maintenance on the nation's main lines, and that has come about without the investment of substantial Federal dollars. It has been done with the investment of private dollars.

You can measure the success of deregulation in the important but less tangible improvements it produced in railroad marketing. Prior to deregulation, railroad marketing was often a contradiction in terms.

The regulatory system offered few incentives and little latitude for the railroad to undertake marketing innovations. And it was difficult to attract top marketing talent to an industry where all of the marketing was done by ICC practitioners and rate attorneys.

Now the carriers still have a ways to go. But under the pressures and opportunities of a deregulated market, we now see price and service innovations like, just-in-time service, reduced rate back-hauls, multiple loading unit grain rates, which were unheard of a decade ago, have become commonplace.

Now, I think we have only scratched the surface of what the railroads will be able to accomplish as the industry grows more familiar with the tools available in a deregulated environment.

You can measure the success of the Staggers Act by its impact on rural shippers. I am not going to argue to the committee that this Act or any other act can undo 30 years of decimation of the Nation's rural rail infrastructure.

But we have halted that decimation, and that is significant. Railroad annual filings before the ICC suggest that the pace of requested abandonments is slowing. It was about 4,500 miles a year on the average in the early part of this decade, dropped to 1,800 miles last year, and 1,300 miles are predicted in the year ahead.

Carriers are making investment in secondary lines that would never have drawn investment in the pre-Staggers era, when cash was scarce.

But the main factor in this turnabout and in the reduction of lines posted for abandonment is the evolution of the short line railroad as an efficient carrier on light density lines.

And the short line explosion has proven that short line carriers can operate efficiently on lines which can not operate profitably within the context of a major carrier. And the Staggers Act created the conditions that allow the short line to flourish.

They gave them the right to contract, which they absolutely need to lock in their traffic base and get their financing. It gave them freedom from the automatic rate protest, which a small carrier can least afford.

And it created the pricing and marketing freedoms that the short line needs to compete with its real competitor, the deregulated short haul trucker.

Proposals that restrict railroad cashflow inevitably produce their harshest results in rural areas. Because in times of cash shortage, the heaviest density main lines are always going to have first call on rail assets. It took us decades to break that cycle, and it serves no one's interest to recreate it.

Finally, there are important indirect benefits of deregulation that accrue to all of us as members of the public. The most significant of those, of course, is safety. And I knew the committee has seen this data before.

But since the Staggers Act became law, the accident rate in this industry has been cut by 62 percent. The track and equipment accident rate, which is a direct reflection of capital investment, has been cut by three quarters in this decade. And no other mode is close to that.

I would like to take credit for that on our safety program, and we have done some of it, but I really can not do it. It is the Staggers Act that has made the difference, because it gave the railroad cash flow. And we have all benefited from that as members of the public.

Finally, if you take a look to the right you will see what it has done for our budget. The budget of this agency and its sister agency has declined from about $3 billion in 1981 to just over $100 million. That is a direct reflection of improving financial health.

Now, I have no intention of representing to this committee that these changes for all their benefit came easily or painlessly. The Staggers Act changed shipping and pricing patterns that had been in effect for half a decade.

There were pains of tradition. There are hard cases which have to be addressed on a case by case basis by the ICC or an equivalent agency. And there are captive shippers.

But the theme that ought to come through clearly, from any oversight of the Staggers Act, is that the railroad industry has not abused its pricing and marketing opportunities.

And because of those opportunities, it has become stable, while providing better shipper service. And while it ought to be clear that no system dependent on human judgments is ever going to be flawless, it should be equally clear that a system which allows market forces and the carriers and the shippers themselves to define their relationship, is better than a system which relies on political appointees like myself to make those definitions.

Those who participated in the adoption of the Staggers Act reforms have received well-deserved credit for those accomplishments. We are now the stewards of those accomplishments.

And the manner in which we address the issues raised at this hearing will have as much impact in the 1990s as the decisions made by this committee had a decade ago.

Let me say just in closing, the CURE bill undercuts the basic philosophical premise of the Staggers Act, by at least inferentially restricting differential pricing, directly reviving price equalization and expanding reliance on the ICC rather than market forces to set price and service levels.

Rather than encouraging the Commission to consider every factor bearing on the issue of competition, it builds its regulatory scheme on economic fictions, by forbidding the Commission to consider real world factors, like intermodal competition, product and geographic competition, and competition from imports.

It would bury railroads and the Commission under an avalanche of paperwork and reporting requirements. And at least in one respect, burden of proof, it actually tightens the restrictions that were on the railroads prior to the adoption of the Staggers Act.

It is, in short, a pervasive reregulation of the railroad industry, and that serves no one's interest. Mr. Chairman, thank you very much. I appreciate the opportunity to come before the committee.

While I know that some of us have differing views on this, I very much respect the problems that some shippers are having in today's environment, which is difficult economically.

And we always strive to work with individual shippers on a case by case basis wherever we can. Thank you very much.

Senator Exon. Administrator Riley, thank you very much. Good testimony.

In listening to your testimony, the basic thrust of it is that the CURE bill is substantially reregulation of the railroad industry, and therefore the advancements that most all of us agree that have been made in the solvency of the railroad industry since Staggers would therefore fall of its own weight.

As you know, there is considerable difference of opinion as to whether or not it does reregulate the railroad industry. But I think most people would agree that it is a step towards more regulation than otherwise. So I do not think there is much disagreement on that.

The question then comes as to whether or not it is a necessary step in this direction, and therefore the interesting testimony that you presented here this morning only bears weight with this Senator if I could be convinced that it is a significant step in the wrong direction.

But the key question that comes to mind is, what has been cited time and time again by witnesses that are in support of the CURE bill. And that basically is that, what in the world are we going to do about small, when I say small I mean relatively speaking, captive shippers that we do have around this Nation, as evidenced by the testimony this morning from Senator Melcher and Representative Boucher?

I seem to feel that your attitude is that things are working well, do not bother us with all of these details, and we will just have to work out the problems of the small, and I emphasize small, captive shippers.

I think we can not go too far in just saying, that is not a problem. Because I think it is a problem. Let me ask this question of you, and then if you could respond to the general thrust of my question.

Do you believe that the ICC has been significantly interested in and protective of the captive shippers since the time that the Staggers Act has been in effect?

Mr. RILEY. If you expect me to defend the ICC procedurally, I think you will be disappointed, because I cannot defend the slowness of movement before the Interstate Commerce Commission.

But I would add that that is not a structural problem in the law. That is a people problem on the Commission. And you cannot solve that by taking the approach the CURE bill takes, which is to throw hundreds and even thousands of more cases before that same Commission.

I share some of the general overviews of the Senator, and you asked me to respond generally to that thrust. Let me do that. There are always going to be hard cases in any environment.

As long as people run any system there will be cases where railroads will abuse a shipper, and shippers will use process to abuse a railroad. But let us put some of these in perspective.

Last year there were 63,000 tariffs filed before the Interstate Commerce Commission. There were 30 protests filed, 30 out of 63,000. And that does not include the 50,000 contracts that shippers and carriers agreed on on their own.

What that tells you is that in an environment that has over 100,000 rail-shipper interactions, you are getting about 30 protests a year. The year before there were 35 out of 49,000.

You simply cannot have a lower level than that in a system run by people, and that is not indicative and it does not support the premise that carriers are abusing the relationship with captive shippers in any systemic way.

Now, I do not defend the speed with which the ICC acts. I frankly think it is disgraceful. On the other hand, when the ICC does reach decisions, shippers won a representative share of them.

They have won about 62 out of, I think, 81, and I am off by one or two on that, market dominance cases, and they have won 21 of 57 rate reasonableness cases. Those numbers do not suggest that the committee is substantively turning away from issues. But it is too slow. And you can not defend McCarty Farms.

As to the small shipper, I guess I would make these arguments. First, the data on rate protest shows very clearly that there is no pattern of systemic small shipper abuse.

Secondly, in the Omaha Power case, the Commission did something very significant, in addition to the fact that it ordered a $20 million rebate to a shipper. It laid out a new set of rules and principles to guide how even a small shipper could calculate stand-alone costs, using publicly available data, and a mathematical formulation.

That, I think, opens the door to the process for shippers who could not have entered that process due to cost in the past. The Commission does have a small shipper proceeding ongoing. It is taking too long to resolve that proceeding.

I filed a statement in that proceeding, and I suggested that the ICC make its office of public assistance available to small shippers, to help them, at public expense, put the elements of their case together.

So while I think that more can be done, I do not believe that the premise that the railroads are abusing their relationship with small captive shippers bears out in any data that I have seen.

I think shippers across the board have benefited from deregulation, because the railroads have lowered their unit costs, and that has affected everyone. Does that mean there is not a case of abuse somewhere? Of course not.

But you do not solve that problem by doing what the CURE bill does, and instead of asking the Commission to handle 35 cases a year, which they do not seem to be able to do, ask them to handle hundreds, and possibly even thousands.

Senator EXON. Thank you very much, Mr. Riley. Senator Kasten?

Senator KASTEN. No questions, Mr. Chairman.

Senator EXON. Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman. Mr. Riley, I always make this plea. I respect you very much, and you are very skillful.

And I have five minutes. I do not know if the Chairman is going to give me a second round. You can decimate my time if you so choose. I hope that you will choose not to do that.

Senator EXON. If I do not, you will take it anyway.

Mr. RILEY. Let me say, that is never my intention, and I will——

Senator ROCKEFELLER. You have already started, sir. If I could get to the questions.

You suggest that the ICC should consider every aspect of competition.

Mr. RILEY. That is correct.

Senator ROCKEFELLER. Should not the ICC also consider every aspect of a railroad's financial health, when they are considering revenue adequacy?

Mr. **Riley**. I think that is right, and I think their current formula does that.

Senator **Rockefeller**. During the last Congress you very strenuously advocated that Conrail be sold to Norfolk Southern.

Do you believe that Norfolk Southern had the financial strength to make that acquisition?

Mr. **Riley**. Yes, I do.

Senator **Rockefeller**. At the time that you were making this recommendation, at the very same time, to this committee and to this Congress, did you know or did you suspect that the two railroads which make up 90 percent of Norfolk Southern's revenues, that is N&W and Southern, would be found to be revenue inadequate by the ICC for 1985?

Mr. **Riley**. I think it was very clear that they would be, even under the CURE bill's formulation.

Senator **Rockefeller**. But you were aware of that?

Mr. **Riley**. I certainly was.

Senator **Rockefeller**. In the tentative decision on the McCarty Farm case, with respect to rate reasonableness, do you believe that the rate reasonable standard in that decision for at least some captive shippers should be the average captive shipper rate being charged for the commodity? Do you agree with that decision?

Mr. **Riley**. I would like to reserve an answer for that in writing, because I have not had an opportunity to really study that case since it came down.

Senator **Rockefeller**. A pretty important case.

Mr. **Riley**. It is a very important case. I have done six hearings since it came down, and I literally have not had time to put the personal time into that, and I would rather give you my answer than my staff's. And I will file that for the record.

Senator **Rockefeller**. All right. Will you have that to us in a week?

Mr. **Riley**. I would be glad to get it to you in a week. In fact, I may do better than that.

[The following information was subsequently received for the record:]

U.S. Department, of Transportation,
Federal Railroad Administration,
Washington DC, June 29, 1987.

The Honorable John D. Rockefeller,
U.S. Senate, Washington, DC.

Dear Senator Rockefeller: During the course of Wednesday's hearings on the Staggers Act and S. 676, you asked me to respond to several questions concerning the Interstate Commerce Commission's recent decision in *McCarty Farms et al.* v. *Burlington Northern, Inc.* No. 37809, served May 27, 1987. Specifically, you asked if I supported the Commission's use of a maximum rate "cap", calculated by computing the average rate-to-cost ratio for captive shipments similar to those of the protesting shippers. You also asked if the Department was planning to intervene in the *McCarty Farms* case, and if I agreed with the ICC's characterization in the decision of the stand alone cost test as burdensome and onerous for small shippers.

As I said on Wednesday, the Department feels very strongly that the complexity or expense of bringing a case before the ICC should not bar shippers from regulatory relief. In the Department's comments in Ex Parte No. 347 (Sub-No. 2), *Rate Guidelines—Non-Coal Proceedings,* filed August 20, 1986, we stated that the stand-alone cost test was appropriate for all commodities and all shippers, but that small shippers, particularly those who are unfamiliar with the regulatory process, should receive special help from the ICC's Office of Public Assistance in preparing their cases. Additionally, I noted that the Commission itself has taken steps to make the stand alone cost analysis easier to perform, through the promulgation of the costing procedures used in *Omaha Public Power District* v. *Burlington Northern Railroad Company*, 2 I.C.C. 2d 1, and subsequent cases.

Although the Department files comments in ICC rulemakings and other policy-oriented proceedings, we generally have not participated in individual rate cases, and we do not plan to intervene in *McCarty Farms*. However, we are still participating in Ex Parte No. 347 (Sub-No. 2), where the maximum rate cap used in *McCarty Farms* was first proposed by the Commission, and will file comments on this methodology by the July 20 deadline.

Our specific comments are still being developed, but in past filings on maximum rate methodologies, we have opposed the use of a rigid formulaic approach because it does not allow the Commission to adapt a rate prescription to the circumstances of a particular case. Moreover, a formula that uses an average level as a cap has the effect of compressing all rates above the average down to that level. As more and more cases are decided, the average becomes lower and lower, significantly curbing the railroads' freedom to price differentially.

We agree that any procedure adopted by the Commission should ensure a small shipper's access to regulatory protections while maintaining a railroad's pricing flexibility. We intend to address the ICC's proposal in more detail in our July filing. I will be happy to provide you with a copy of our comments when they are filed.

Yours very truly,

JOHN H. RILEY, *Administrator.*

Senator ROCKEFELLER. All right. The ICC characterized the stand-alone cost as being complex, onerous and economically burdensome. Do you agree with that?

Mr. RILEY. I do not agree with that because I believe that the stand-alone cost test that the ICC outlined in Omaha Power, I think that was certainly true the way the ICC applied the procedures up to the Omaha Power case.

But I think the rules of the game defined in Omaha Power opened the door to that to every shipper. And you know, the CURE bill does not replace it. It does not have any suggestion on what could be better.

It simply says to the ICC, scrap what you have done now and go back to start. And I do not think that is going to better the situation for any shipper. It just means more delays.

Senator ROCKEFELLER. On the matter of market dominance, Mr. Riley, I have a very immediate concern about product and geographic competition.

My coal producers in West Virginia are losing business because of high railroad rates. They tell me that, and I know that to be true.

If one or a group of them want to bring a rate case at the ICC, what meaning does product or geographic competition have for them?

Mr. RILEY. The thrust of product and geographic competition in a coal case is simply this. The railroads have an enormous investment in the infrastructure that serves those mines.

If rail rates are set at a level that make domestic coal non-competitive with coal coming from other locations within this country, from other mines within that service area, or from other countries, the railroads have just priced themselves and their shipper out of the market.

Now what that means is that product and geographic competition is a real restraining factor, not in all cases, but in some cases in the coal environment.

That was illustrated by New England Electric and Central Power of Texas, purchasing very small quantities of foreign coal recently to illustrate to railroads that they had other product and geographic sources if, in fact, carrier rates were not restrained.

It is not dominant in every case. But it does exist in some and the Commission ought to be able to consider it and weigh it.

Senator ROCKEFELLER. Mr. William Skewes, a coal producer in West Virginia, who was here last week, and he told us the meaning of geographic competition as he understood it.

He said how he had worked hard to keep his mines open, to be innovative, to reduce costs, worked very hard with United Mine Workers to be good there. And he has been trying to sell coal to France, Turkey, and Egypt.

But at times he has tried to call Norfolk Southern and has not even been able to get a phone call returned. Now, he has been trying to get rail rates reduced. From his point of view, that would be an impact of geographic competition. Would it not be?

Mr. RILEY. Well, frankly Senator, from that comment I can not tell. He is arguing there that he can not export coal. I guess I am just not sure from that description.

Senator ROCKEFELLER. Well, let me put it a different way.

If he says that he is losing or will lose business, or has lost business to foreign competitors, therefore to geographic competition, as you and I are discussing it, would not the ICC find that there was no market dominance here, regardless of the rate?

Mr. RILEY. That is not true, because in the agreement between the AAR and the National Industrial Transportation League, which most shippers have accepted on this issue, it is expressly agreed that product and geographic is a factor to be weighed in determining competitive balance, but is not per se determinative in a case. It would depend on the facts of the case.

Senator ROCKEFELLER. Well, we may have some disagreement on that, Mr. Riley. You would then disagree that Mr. Skewes would be barred from raising the rate question before the Commission, based upon product and geographic?

Mr. RILEY. It would not per se bar him. It would be one factor that the Commission would weigh in determining whether market dominance existed, and then whether that would be a market dominant situation would depend on the facts of the case.

But I have to say, the shippers have won more than three quarters of the market dominant cases decided by the Commission. The problem is, it takes them too darn long to decide them. The shippers have done very well in those cases, when the Commission has decided them.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Senator EXON. Thank you. Senator Danforth.

Senator DANFORTH. Mr. Chairman, thank you very much.

Mr. Riley, clearly all of us are concerned about captive shippers. I oppose the CURE bill. You have stated your negative views about the CURE bill.

Clearly if we are not going to change the underlying law, we are relying on an administrative agency, namely the ICC, to take care of problems that could be taken care of by statute.

Your testimony is, in essence, that the ICC is all thumbs. My impression has been, at least in the recent past, it has been somewhat more responsive to the problem of captive shippers.

Do you think that the ICC is on the right track? Or is it just hopelessly bumbling? Or what? And the second part of the question is, if there is room for improvement in the ICC, what do you think that we should do to encourage that improvement?

Mr. RILEY. I do not think that the ICC is all thumbs. I went out of my way to distinguish between my impressions of the rapidity with which they have moved cases, and the fairness of the judgment they have made in those cases, in my earlier testimony.

I do think that there has been a very noticeable improvement, even in the rapidity with which they have moved cases in the last two years. The Commission has regained control of its docket. There is no question about that.

And they have decided some of the big ones that have been pending, and I give the Chairman a lot of credit for that. That was a difficult thing to do. Now, going beyond that, I have given a lot of thought to what procedures could make the Commission move quickly.

And it is not easy to devise an answer to that. I visited our Canadian colleagues, who are putting together a new deregulation proposal to get their idea. One thing they are incorporating in their proposal is a final offer arbitration provision, which may merit some inspection.

I am not endorsing it, but I am saying it is an interesting idea. It is one I want to look at. The problem is that if you put time limits on Commission decisions, the Commission can violate the time limits and there is really no sanction.

I do believe that the Commission has all the tools that it takes to be an effective moderator. I agree wholeheartedly that the Commission has substantially improved its performance.

In fact, I hear more complaints from railroads now about the performance of the Commission, based on the cases they have lost in the last two years, than I think I had in all of my previous years, which shows me that there is balance.

I wish I had a tangible suggestion for how one makes anybody move faster. I do not have a tangible suggestion on that, I am afraid, Senator. I just do not.

Senator DANFORTH. Well, it is not in the same field, but back in 1979 we addressed the question in the Finance Committee on how to make anti-dumping and countervailing duty cases move more quickly.

And we put into place at that time a lot of procedural changes, kind of technical changes, that I think had a positive effect. Is anybody giving any thought as to the appropriate procedures?

This is, I take it, a procedural problem?

Mr. RILEY. I tend to think that it is more of a human problem in the dynamics of the way the Commissioners have related to one another.

I am not saying there are good guys or bad guys on that. But it seems to be the problem of a collegial body reaching a point of consensus.

Senator DANFORTH. Do they have deadlines?

Mr. **Riley**. They do have some deadlines in the merger area. Beyond that, I could not tell you.

Senator **Danforth**. Should we look at deadlines? Is that something that we in Congress should pursue? Some way to make sure that the ICC moves on cases and decides them expeditiously?

Mr. **Riley**. I certainly would not oppose the use of deadlines, because if they are not strictly enforceable, they are at least a measure of guidance or a benchmark that the committee can use to measure the Commission's performance against.

Again, I think there are really good signs coming out of the Commission now, that they have got all their cases docketed and scheduled, they are beginning to move on the big ones. There is real evidence that the problem is abating.

But by the same token, there are still a tremendous number of cases backlogged in the Commission, and I would not oppose that.

Senator **Danforth**. Well, is it something fruitful for us to pursue?

Would you suggest that instead of carrying on this endless debate about the desirability of the CURE bill, maybe we should look at procedural issues instead and attempt to keep the jurisdiction within the ICC, rather than transforming the decision-making, in effect, to Congress with the CURE bill. Should we instead proceed with more procedural legislation?

Mr. **Riley**. I think that deadlines are a good idea in principle. I think that every possible procedural avenue to improve the responsiveness of the Commission ought to be looked at.

The only thing I would oppose are these kinds of doomsday or ratchet clauses, where if you do not decide by a certain day, something happens automatically, because this is a world in which it is much too complex to have automatic responses.

But short of that, and I think final offer arbitration merits a good look. We are looking at it now. So I would agree with that. I do not think there is a problem with the Commission's powers.

And you certainly are not going to solve that by doing what the CURE bill does and making it so easy to get so many more cases into the Commission.

Senator **Danforth**. Would you look at the possibility of procedural remedies and get back in touch with me, or anyone else who is interested, and give us your ideas?

Mr. **Riley**. I would not only be glad to do that, but I would be glad to assign a member of my staff to work with the Senator and with the Chairman to just make sure that we have an inventory of all available ideas on that, to take a look at and consider.

I would be very happy to do that. I think that is constructive.

Senator **Danforth**. Thank you.

Senator **Exon**. Senator Adams?

Senator **Adams**. Thank you, Mr. Chairman. I got my arm broken in a charitable event, and I want to be charitable to the railroads this morning, if possible.

I have two areas of inquiry. One on the ICC first. What do you think about going back up to nine and going to divisions as we had before and clearing out that caseload?

Mr. **Riley**. Well, there is no administration position on that. I personally, when I was advising my Senator on that issue five years ago, suggested that I thought the reduction to five would ultimately prove counter-productive. I am personally inclined to think there may be merit in that.

Senator ADAMS. All right. Second question. As I remember, when we were doing Staggers, you indicated that Conrail has a relatively shaky long term future, even though a lot of us were arguing it was making a lot of money. Is that not correct?

Mr. RILEY. That is correct. In fact, let me say precisely what——

Senator ADAMS. Wait a minute. I am like Senator Rockefeller. We both know one another. I want to ask some questions, and I only have five minutes.

This was based on long term trends in the northeast. Was it not?

Mr. RILEY. Partially, on long term trends in the northeast.

Senator ADAMS. But we had refurbished the railroad and it was making some money.

Now, Senator Rockefeller asked you, and which I am aware of, that neither of the two basic lines of the Norfolk Southern are revenue adequate under the ICC tests, and therefore market dominance does not kick in. Is that correct?

Mr. RILEY. Well, no. That is not correct. Neither are revenue adequate under the ICC or under the CURE test, but that does not preclude market dominance from kicking in.

Senator ADAMS. However, it is a major test.

Mr. RILEY. The Commission has not defined what impact revenue adequacy has on its ratemaking decisions, but not on market dominance. That is not a market dominance issue.

Senator ADAMS. All right. But one of the things that we are trying to do is, since we have got a Commission that has got a few problems, is tell them what to do.

And I am a great believer in not sending to either secretaries or independent agencies a blanket kind of mandate and then saying, now, you make reasonable regulations. I think that is a very bad practice for the Congress that we have pursued for many years.

So I want you to contemplate on that a little bit. Because it leads to the question that, if they are not revenue adequate, you did say that they could buy Conrail and that they were a great financial strength to do so. Did you not?

Mr. RILEY. I said they were stronger than Conrail and that by connecting Conrail's short north-south routes with their long north-south routes, you created a synergy that made the whole greater than the sum of the parts. And that was the essence of my argument.

Senator ADAMS. And they had to borrow money. Did they not?

Mr. RILEY. Yes, they did. They financed it like any other purchase would be financed.

Senator ADAMS. Right. Now, you have indicated in your testimony, and I will not try to get into the details, on the test, we have got a revenue inadequate determination being made by this agency.

And we have got the Department of Transportation saying, you can buy Conrail and borrow a lot of money, at present rates. And I do not think the two of those are very consistent.

Because if you are going to load up a low earning, high debt transportation system to buy another transportation system, it seems to me a little disingenuous to argue that we can not say that they should do a little something for the captive shippers.

Mr. RILEY. The borrowing that is done to finance that kind of acquisition is based on the cash flow of the entity being purchased, and that is why you can have extremely small companies in any frame of business buy much larger ones.

Senator ADAMS. Yes, but you and I have agreed that that cash flow is shaky for any kind of a long term proposition. So Conrail was, in the view of your department, not that great a deal over the long term.

Mr. RILEY. That is the essence of our position, and it is that Conrail was shaky because its north-south lines were too short.

That if you associated them with the Norfolk Southern's lines, that length of haul produced a whole that was greater than the sum of the parts, and became strong.

Senator ADAMS. All right. Well, that is what I am getting at, is that I have not come down and tried to make a decision and say what you should or should not.

But I am concerned about the fact that you can borrow to buy, whether leveraged or otherwise, and yet you are revenue inadequate as far as captive shippers are concerned, and the ICC is not functioning.

And that, it seems to me, is what the Chairman and the committee are trying to address here, is what do you do about these captive shippers?

Your testimony indicates, and certainly the real world does, that if you do not like what is going on with a smaller shipper, and you are in a monopoly situation, that one of your options is to peal it off, abandon it, or as you say, concentrate your resources someplace else.

Now, I would like to have you in writing [1] give me a little dissertation on how those things are consistent.

Mr. RILEY. I think they are very consistent.

Senator ADAMS. I am sure you do, so that is why I want it in writing, because I know the Chairman wants to proceed, and I am willing to have you come and talk to me about it.

But I want you to give me some idea about how, because I do not like a spinning system of buying and selling and merging and playing the paper game, while the operating area operates on a different set of rules.

Mr. RILEY. I would be glad to do that. And bear in mind that for all the success of our Conrail sale, and it was successful, we still ended up selling that company for 50 cents on the dollar of its book value in a deregulated environment. And I think we would have done worse than that if there had been a regulated environment.

Senator ADAMS. Well, we all helped you a little bit with that.

Mr. RILEY. The point is that the bottom line, sale price does not reflect the type of strength that would give one latitude to go back and reregulate and cut into that railroad's cash flow. And I am sure Conrail agrees with me today.

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[1] See p. 612.

Senator **Adams**. Thank you, Mr. Chairman. We will discuss it further.

Senator **Exon**. I would just put in a little caveat. We assisted them in the sale, but we made a much better sale than was contemplated by the administration, in my view.

Senator **Adams**. That is what I was trying to say, Mr. Chairman.

Mr. **Riley**. I understood that inference, Senator.

Senator **Exon**. Senator Pressler?

Senator **Pressler**. Mr. Chairman, let me commend you on these hearings on the Staggers Act.

In my State of South Dakota, we have a real transportation problem in moving grain and other products. The same thing is true in upstate New York or parts of California, or where there are not great urban centers. So it is not just a South Dakota problem.

So I have been pleased to see this review. I am particularly interested in the short line railroads, of which we have some in South Dakota.

I am very worried about what is going to happen down the road in terms of some of the labor rules and some of the competitive access issues. Often the little guys, so to speak, do not have enough horsepower to deal with the giants.

But things seem to be better today than they were just a few years ago. One area that has not been covered in the questioning so far is the subject of competitive access.

Now, how would the CURE bill's treatment of competitive access affect the industry, first of all, and second of all, shippers?

Mr. **Riley**. I think they would affect shippers very negatively, because it would mandate competitive access in a broad range of cases.

Now there are some cases, like the Powder River, where the introduction of the second carrier will not raise shippers prices, because the volume being shipped is so great that the volume increases upon the introduction of a second carrier, and thus unit costs do not go up.

In that case, you can have long term rate reductions. But, in the more common case, let me give you a hypothetical, a small agricultural branch line. Say it ships out 1,000 grain cars a year.

You put two carriers on that line, they each now have 500 units across which to spread their costs instead of 1,000. So while you may have created competition, you have doubled the unit costs of both carriers, and inevitably that is going to drive prices up for the shipper.

So what I am saying is that the adequacy of competitive access as a solution in these cases varies from case to case. You have got to give the Commission discretion.

If you mandate broadly the presence of competitive access response on demand, you will hurt at least as many people as you help in the shipper community, probably more, because there are more small grain lines than there are Powder Rivers.

And the CURE bill has rate equalization in it, which I think was a devastating thing to shippers in the pre-Staggers era, and would be equally damaging to them today if it were revived. Because what it inevitably does is it ratchets rates upward to the level needed by the least efficient shipper.

Senator **Pressler**. I am very interested in this subject. I shall have some written followup questions on competitive access that I could not get asked during the time allotted to me here.

Let me turn to another problem. I am concerned about potential short-line labor protection amendments to this legislation. They have shown up mostly over in the House.

I am not anti-labor. I think the dignity of the working man is a very important thing. And unions have done a lot of positive things. There have been negative things in areas in terms of featherbedding and so forth.

But nevertheless, many of these short lines face a choice between a new labor agreement or no jobs at all. In terms of these regional and short-line railroads, what would be the impact on them if labor protection is imposed?

Mr. **Riley**. I think it would be a terribly negative impact, and I do not think that is an anti-labor position. It is going to cost jobs.

The premise of the argument that the RLEA raises on this is that, when lines are abandoned, the employees do in fact get paid labor protection, and that is not true. You and I both know from the history of our region that the railroads are not going to pay labor protection.

Previously, they would abandon a line rather than sell it. Because if they sold it they had to pay protection for the whole workforce.

However, if they simply allowed it to deteriorate, did not invest in it, allowed the service to go through the floor, they could lay off the workers under the decline in business clause common to all labor contracts, and then abandon the line and pay protection to just a handful of people.

So in fact labor protection was not paid to employees on lines being abandoned. Now, the ICC recognized that, and that is why in the Gulf & Mississippi decision they created an incentive for carriers to preserve surface rather than destroy it, by allowing them to sell these lines to independent companies free of that labor protection.

And you know what the result is. One third of all the short lines formed in this country have been formed since Staggers. There are lines that are operating today that would have been ripped out of the ground under the pre-Staggers system.

And if we impose labor protection on short lines who are least able to pay them, we are going to cost jobs, we are going to cost service, and the railroads will simply stop selling lines they want to spin off.

What they will do is allow them to deteriorate, allow the service to deteriorate, cut back capital investment, use the decline in business clause, and abandon them just the way they used to back in the 1970s. And that is not in anybody's interest.

Senator **Pressler**. Then there will be less total jobs, both in the main line and the short line.

Now, is what you have said about your views on short-line railroads and labor protection the official position of the administration?

Mr. **Riley**. That is the position of the administration, and it is a position that I developed from my personal experience in working with light density lines in Minnesota.

Senator **Pressler**. Is the administration lobbying on that position? Have you been expressing that officially as a part of the administration's position?

Mr. **Riley**. Well, we certainly cannot lobby, as you know. We have expressed that position officially any time asked and in any forum, because I think that is a very important issue.

And I think labor means well on this. They are just wrong.

Senator **Pressler**. Thank you.

Senator **Exon**. Thank you, Senator Pressler. I appreciate your line of questioning.

I wish to admonish you only that the Chairman had agreement that we would end with your questioning. You went on 30 seconds too long, and therefore Senator Rockefeller has asked for one question.

I would hope that you could use your usual restraint and keep your answer down as short as possible, Mr. Riley.

Senator **Rockefeller**. Mr. Riley, first just a request. When you do—I am disappointed that you are not going to reflect on the McCarty decision this morning, because I think you are in a position to, but you evidently choose not to. When you do reflect on it, and if you do decide that you do not agree with the formula that has been placed—that I would call a cap—which has been placed on some shippers, would you also in your response to me, tell me whether the Department of Transportation will then intervene in the event you do not agree?

Mr. **Riley**. I will be glad to do that. And I will have that answer to you this week.

Senator **Rockefeller**. Good. My only question to you is, are all of these coal shippers in West Virginia and Appalachia, and some of the grain shippers that we hear from around the country, are they all just stupid and crazy in their complaints?

The fact that it costs maybe a half a million dollars, or a million dollars, to put up some type of stand-alone cost test; the fact that 85 to 90 percent or more of the coal shippers in the State that I represent and the State that Congressman Boucher and others represent are captive shippers; and that they are all angry about this; and that coal is an area in which we can increase our balance of trade with other countries, or reduce our balance of trade with other countries.

And they all complain, and none of them disagree, and they are all unhappy. And they cannot get into the Interstate Commerce Commission. And if they get up the money to do it, it takes them years to not get a decision.

I mean are they all crazy? Why is your fervency so strong that you do not give them some attention? You say, yes, they may be captive shippers, but you do not seem to worry about them.

Mr. Dempsey is going to try to say that it was not correct that a billion-four, all the profits of the railroad industry came off the captive shippers.

But he will be wrong, if he tries to say that, as he was right when he agreed to it the last time.

Now why are you not concerned about this, and why are you not helpful about it, as opposed to just blasting the CURE bill, which does not reregulate pervasively, as you know it does not?

Why are you not more concerned about these captive shippers?

Mr. RILEY. I will try to give that a brief answer.

Senator EXON. I would extend automatically the time restraints that I put on you, Mr. Riley.

Mr. RILEY. I will still try to be brief. My point is this: Coal rates, which went up faster than inflation prior to Staggers have gone down in current dollars by almost 6 percent since Staggers.

The railroads have declined to take the inflation increases they were entitled to take, and have frozen export coal rates for the last 5 years to help the coal industry.

The railroad's revenue for ton-mile on coal is lower today than it has been at anytime since 1972.

The point I am making is, could the price of coal be lowered if rail rates were lowered? Probably, yes. But it could also be lowered if wages were lowered. It could be lowered if taxes were lowered.

That does not mean that those are the right solutions. The railroads have treated the coal companies fairly. The data bears that out.

Now, when you have only 24—I am sorry, when you have only 30 protests out of 63,000 rate interactions, it does not demonstrate a pattern of abuse.

Finally, although I could say more——

Senator ROCKEFELLER. It does not demonstrate a pattern of abuse if you have the money to bring the case. What if you do not have the money to bring the case? What if you do not think you have the time to bring the case, if it is going to take all that time?

It takes time, you know, and money.

Mr. RILEY. Two answers to that. The ICC and the Omaha Power case has set out a very clear, reliable and functional test to be used in establishing stand-alone costing for small shippers.

I think they can do more. I have filed in support of doing more in their small shipper proceeding, which is now in process.

As to grain and wheat growers, I notice that the National Association of Wheat Growers and the National Corn Growers Association both filed a statement yesterday opposing broad-based reregulation of the railroad industry, and saying some nice things about their experience under Staggers, and I would like to submit that for the record.

These are complex issues. There are hard cases. But one cannot argue anecdotally on this issue. You cannot take the 30 hard cases, and expound that into a systematic abuse in the more than 100,000 interactions that are going on in this economy.

That is my view.

Senator EXON. Mr. Riley, thank you very much. We do not always agree, but you have been very forthcoming, as usual, and we appreciate your being here this morning.

I will now call on our next panel.

Mr. RILEY. And I try to be concise.

[The statement follows:]

STATEMENT OF HON. JOHN H. RILEY, ADMINISTRATOR, FRA

To assess the real impact of the Staggers Act, it is essential to bear in mind where we were 8 years ago, and contrast that environment with the industry we know today.

When this Committee debated the Staggers Act in 1980, nearly one-quarter of the nation's track was in bankruptcy reorganization. Forty-eight thousand miles of track were under slow order because railbeds were not in sufficient condition to permit trains to operate safely at normal speeds.

Nine major railroads had collapsed during the relative prosperity of the mid-70's, culminating in a complete collapse of the rail systems in the Northeast and upper Midwest.

Even the strongest railroads had a tenuous hold on stability. Return on investment industry-wide had hovered between one and two percent for two decades. Because investment needs had outstripped retained earnings for 19 of the previous 20 years, the railroad industry faced a 10 year cumulative capital shortage of more than 13 billion dollars.

There weren't any winners under the regulatory system this Committee altered in 1979. The problems afflicting railroads touched every employee, every shipper and every community that depended on railroad service.

Poor cash flows meant deferred maintenance, which translated into derailments, slow turnaround times, and generally unreliable service. Car shortages, particularly in coal and grain service, reached epidemic proportions. But while all shippers were affected by these conditions, rural shippers were unquestionably the hardest hit. When the railroads became cash poor, they did what any sane business person would do in the face of a cash shortage—they focused what resources they had on their heaviest density mainlines, where they earned their greatest return. Branch lines and secondary mainlines suffered the brunt of the cash shortage.

Unfortunately, there are few mainlines in rural America, and that starvation of secondary and branch lines produced a 20 year cycle of deterioration that cut deeply into the vitality of America's rural rail infrastructure.

How bad was it? In 1979, FRA recorded a new type of accident—the standing derailment. A standing derailment is exactly what its name implies. It's a freight car standing perfectly still that just falls off the tracks.

In my part of the country, we had a stretch of the Rock Island known as the "miracle mile." The engineers gave it that name because they considered it a miracle if the train got across without derailing.

These stories seem humorous today, but they were reality just 8 years ago. The railroads were on their knees, and Congress had only two choices—nationalize the industry, or deregulate it. The result was the Staggers Rail Act of 1980.

The concept behind the Staggers Act is relatively simple, as regulatory statutes go. Its provisions are keyed to rate levels.

Rates are permitted to fluctuate differentially depending on shipper demographics and competitive conditions. Rates at or below 180 percent of variable cost are considered reasonable per se, and not subject to maximum rate regulation. Rates above 180 percent of variable cost remain subject to regulation. These relatively simple concepts represented a radical change from the regulatory system that had governed the industry for more than 50 years. And the contrast between "then" and "now" is the best testimony to the wisdom of the decisions made in this room 8 years ago.

You can measure the success of the Staggers Act in the revival of the railroad industry.

Today's railroad industry is financially stable for the first time in nearly three decades. It survived the deepest recession since the 1930's without losing a single Class I carrier. And while time-frames are still too short to establish a definitive trend, the railroads appear to have slowed if not stabilized the annual declines in market share that characterized the industry for decades.

But there is an important distinction between stability and financial strength. For all their improvement in financial performance, railroads remain one of the least profitable American industries. Over the past twelve calendar months, the railroads generated an average rate of return of 3.95 percent—a revealing figure, because it tells both sides of the story. 3.95 percent is real improvement for this industry, far in excess of the returns it generated before deregulation. But at the same time, only a railroad or perhaps a farmer would show unrestrained ecstasy over a 3.95 return on investment (ROI). An investor could do better by putting his money in a passbook savings account. As the nation's utilities have argued so persuasively—and correctly—in their own rate cases, an industry that cannot generate a return on capital equal to the cost of borrowing is an endangered species. These ROI figures emphasize the extent, and at the same time the fragility, of the industry's recovery. The progress is real, but it would not take much "fine tuning" to erode it.

You can also measure the success of the Staggers Act in the pricing benefits it has delivered to shippers and consumers.

Shippers and consumers have benefitted enormously from the price compression that resulted from competition among partially deregulated railroads, a substantially deregulated trucking industry, and a barge industry never subject to bulk commodity regulation. As the following data illustrate, railroad prices have moderated substantially in every major commodity group since the Staggers Act became law.

CHART A.—ANNUAL CHANGES IN RAILROAD RATES AFTER INFLATION BEFORE AND AFTER THE STAGGERS ACT

[In percent]

	October 1975–October 1980	October 1980–October 1985	December 1985–December 1986
All commodities	3.0	−0.6	−2.4
Farm products	2.8	−0.6	−3.6
Coal	3.4	−0.4	−2.5
Chemicals	2.5	−0.6	−2.1
Primary metals	2.1	−1.0	−2.5
Automobiles and parts	1.7	−1.6	−2.1

Where average prices generally rose faster than inflation in the pre-Staggers era, they have failed to keep pace with inflation—and in many cases actually declined—since the onset of deregulation. This pattern tracks across virtually all commodity groups, including coal and grain, where many of the captive shippers are found. Average coal rates have declined 5.9 percent (after adjusting for inflation) since Staggers, and average grain rates are down a remarkable 28 percent in current dollars (or 44 percent when adjusted for inflation). The decline in coal rates is probably more dramatic than these numbers imply, because they reflect only published rates. They do not take account of the 50,000 rail-shipper contracts, which generally incorporate rates below those prevailing in the published traiffs.

The bottom line is again a simple but important one: railroad prices have moderated, not increased, since the passage of the Staggers Act.

You can measure the success of the Staggers Act in the increased efficiency of America's railroads.

Today's railroad industry serves approximately the same market share it served 7 years ago with 20 percent fewer locomotives, 150,000 fewer employees, and thousands fewer freight cars. Make no mistake, these are positive developments—changes that would have taken place years ago had regulation not impaired the carriers' ability to adapt to demographic changes taking place around them. And it was the shipper and the consumer who paid the bill for these inefficiencies.

Under pre-1980 regulation, railroads could tolerate this kind of inefficiency, and simply pass much of the cost on to consumers. That changed with the onset of deregulation. Railroads have been forced (at times against their tradition) to reduce costs and pursue operating efficiencies in order to compete effectively. They have restructured their systems to emphasize the most efficient routes, and taken a firmer stand against anachronistic work rules. These are systematic changes which have benefitted all shippers, competitive or captive, by lowering the carrier's unit costs and improving their service.

It's this process that has enabled the railroads to regain economic stability while at the same time reducing rates. And the consumer has been the biggest winner in this process.

You can measure the success of deregulation in the rebuilding of America's rail infrastructure, as railroads utilized the cash flows generated by deregulation to reconstruct thier physical plant.

Average annual investment in roadbeds and structures has more than doubled since deregulation became law. Overall, railroads have invested more than $32 billion in their systems since deregulation, and it shows in increased innovation, faster turnaround times, and more reliable service. Deferred maintenance has been virtually eliminated from the nation's rail infrastructure has been accomplished primarily with private rather than public financing.

You can measure the success of deregulation in the important but less tangible improvements it produced in railroad marketing.

Prior to deregulation, railroad marketing was often a contradiction in terms. The regulatory system offered few incentives and little latitude for price and service innovation. And the railroads found it difficult to attract top marketing talent to an industry where marketing was done primarily by rate attorneys and ICC practitioners.

Railroads still have a long way to go, but the pressures and opportunities of a deregulated environment have progressively altered their marketing philosophies. Price and service innovations like "just-in-time" service, reduced rate back hauls, double stack trains, and multiple loading unit grain rates—unheard of a decade ago—are now commonplace. The right to contract—which enabled a significant role in easing the grain car shortage. And I think we have only scratched the surface of what the railroads will be able to accomplish as the industry grows more familiar with the tools available in a deregulated environment. If, on the other hand, we restrict those rate making freedoms, we threaten the continuation of that progress in a real and meaningful way.

You can measure the success of the Staggers Act by its impact on rural shippers.

For all its positive impact, the Staggers Act will never undo the decimation of the nation's rural rail infrastructure that occurred during 30 years of overregulation. But it has put a stop to that cycle of deterioration, and that is meaningful progress.

Railroad filings before the ICC suggest that the pace of requested abandonments—which averaged more than forty-five hundred miles of line per year in the early part of this decade—slowed progressively following the passage of the Staggers act to approximately eighteen hundred miles by 1986. Carriers have made investments in the rehabilitation of secondary lines that would not have been made during the pre-Staggers era, when profits were low and cash was scarce. The main factor in this turnabout is the evolution of the short line railroad—which has proven its ability to operate profitably on lines too marginal to survive in the economics of a Class I railroad. There has been an explosion in the number of short line railroads formed over the past 5 years, and many of these carriers are operating trackage that would have been torn from the ground in the pre-Staggers era. The Staggers Act has played an important role in the success of the short line railroad by creating a market environment that permits short lines to flourish. By establishing the right to contract, the Staggers Act made it possible for short line organizers to lock in their traffic base, and thus provide financial institutions with the type of firm volume guarantees that are critical to acquiring financing. Even more important, the Staggers act freed the short line railroad from the threat of the automatic rate protest. Short line railroads lack the resources to engage in repeated ICC rate proceedings, and their success depends on their ablity to match the price and service flexibility offered by the subsantially deregulated short-haul trucker.

The growth of the short line railroad has preserved service in rural areas where service could not have been sustained by a Class I railroad. And the Staggers act has played a meaningful role in that success. Proposals to restrict Staggers Act ratemaking freedoms, or legislate labor protection provisions in short line transfers, strike at the heart of the short lines' economic viability. And by doing so, they diminish the viability of the marginal branch line.

From the broader perspective, proposals that restrict railroad cash flow will inevitably produce their harvest results in rural areas, because in times of cash shortage, the heaviest density mainlines will always have first call on railroad resources. It took decades to break that cycle, and it serves neither the railroads' nor the shippers' interests to recreate it.

Finally, there are important indirect benefits of deregulation that accrue to all of us as members of the public.

The most significant of those public benefits is the remarkable improvement in railroad safety that followed the industry's financial recovery. The Staggers Act enhanced the industry's cash flow, and the railroads more than doubled their annual investment in roadbed and structures in the post-Staggers years. While those investments were made primarily to improve efficiency, the improvement in roadbeds and operating equipment has generated a dramatic reduction in accident statistics. The accident rate in the industry has been cut more than 63 percent since the Staggers act became law in 1980. As the following data indicates, those improvements track across virtually all areas of railroad accident performance.

CHART B.—RAILROAD SAFETY—1986

	Percent change	
	1983–1986	1979–1986
Accidents	−30.6	−70.9
Accident rate	−31.7	−62.8
Track/equipment accidents	−34.6	−75.2
Workplace injuries	−26.4	−66.5
Grade crossing accidents	−10.7	−48.9
Train movement fatalities	−30.8	−56.4

No other mode of transportation can match this improvement, and the Staggers Act was the major factor in bringing it about.

The public has also drawn substantial fiscal benefit from the industry's financial recovery. Before railroad deregulation took effect, federal agencies distributed during the peak year of 1981 $2.8 billion in subsidies to financially troubled railroads. The following chart illustrates how those subsidies have declined in succeeding years as the industry regained financial stability.

CHART C.—*Federal funding for railroad freight services*

[Millions of dollars]

Fiscal year:	*Funding*
1981	$2,831.9
1982	1,151.1
1983	213.0
1984	450.7
1985	158.1
1986	102.1

In gross numbers, annual rail subsidies have been cut by close to $2.7 billion as a direct consequence of the financial improvements made possible by a deregulated environment.

I have no intention of representing to this Committee that these changes, for all their benefit, came easily or painlessly. The Staggers Act changed shipping and pricing patterns that had been established for nearly a half century. There were pains of transition. There are, in fact, hard cases which must be addressed on a case-by-case basis.

But the theme that should come through clearly from an oversight of the Staggers experience is that the railroad industry has not abused its pricing and marketing opportunities, and because of those opportunities, has become stable while providing better shipper service. It should also be clear that while no system dependent on human judgments will ever be flawless, allowing the commercial relationship between shippers and carriers to be shaped by market forces produces better results, for shippers and carriers, than a system which delegates the major share of those decisions to a board of political appointees.

Perhaps, in the end, the most significant accomplishment of Staggers lies in the fact that it has forced shippers and carriers to work directly with one another, to address their own problems and develop their own compromises. The success of that system can be measured in 50,000 contracts, and in the historic agreements between the major shippers associations and the Association of American Railroads (AAR) on difficult issues such as joint rates and product and geographic competition. In contrast, a system in which ultimate pricing and contract decisions must be referred to an appointed board of arbitrators is a system which creates incentives for the parties to defer, rather than resolve, the issues of greatest importance in their relationships. It was a slow and cumbersome process, one in which marketing was done by rate attorneys and ICC practitioners. It was a process that served the public and the shipper poorly.

Proposals such as the "CURE bill" directly threatened much of what the Act has achieved. It's interesting to note that in their more recent presentations, advocates of the CURE approach have gone to great lengths to argue that their bill is nothing more than minor "fine tuning" of the Staggers Act reforms. That's a revealing shift in emphasis, because it reflects the growing recognition that the Staggers Act reforms are fundamentally sound, and have been generally well received by the shipping community. It is also a dangerous characterization, because the provisions of that proposal—on burden of proof, on the treatment of product and geographic competition, on rate reasonableness benchmarks, and on many other issues—represent a change in the philosophy underlying today's railroad regulatory system.

The CURE bill undercuts what we believe to be the basic philosophical premise of the Staggers Act by restricting differential pricing, reviving price equalization, and expanding reliance on the ICC, rather than market forces, to set price and service levels. Rather than encouraging the Commission to consider all factors bearing on the issue of competition, it builds its regulatory scheme on economic fictions by forbidding the Commission from considering such real world factors as intermodal competition, product and geographic competition, and competition from imports. It would bury the railroads—and the Commission—under an avalanche of paperwork and reporting requirements. And in at least one respect, its "burden of proof" provision, the bill actually tightens the regulations that preceded the Staggers Act. It is, in short, a pervasive re-regulation of the railroad industry.

While the problems inherent in this approach can be illustrated through a number of the bill's provisions, the following are representative of the bill's overall impact and intent.

1. Section 7 would declare a railroad revenue adequate if its earnings were sufficient to cover historic cost of borrowing, rather than the costs it must incur to borrow in today's market.

Since this Committee debated the Staggers Act one year ago, the ICC has adopted most of the CURE group's proposed amendments to the revenue adequacy formula. But it refused to adopt this amendment—and for good reason.

The point of the revenue adequacy calculation is to determine whether the railroads are earning enough to support the cost of capital acquisition today. Whether they are earning enough today to support the cost of borrowing 10, 20, or 30 years ago could not be less relevant. Thirty years ago, the prevailing home mortgage rate was about 3½ percent. The fact that a person earns enough today to support a 3½ percent mortgage is hardly a measure of his current ability to buy a home. And on a larger scale, the situation is no different with railroad companies.

Railroad investments tend to have extremely long useful lives. Even today, carriers retain in their investment base millions of dollars in capital investments with financing costs in the relatively low levels that prevailed in the 60's and early 70's. That is the very property now reaching the end of its useful life, and it is absurd to suggest that the ability of the railroads to replace that property can be measured by the cost of financing it 20 or 30 years ago. This provision is simply an artificial mechanism to depress railroads' earnings below the level actually needed to retain their plant and equipment in top operating condition. Ultimately, this provision could come full circle to backfire on the shippers who proposed it when property financed at the higher historic (19-21 percent) borrowing costs of the late 1970's cycles up for replacement.

2. Sound public (and economic) policy requires the Commission to weigh every factor that bears on the issue of whether competition exists in real world markets. Common sense suggests that its decisions will be wiser, and more consistent with actual economic conditions, if they reflect all factors that influence shippers and carriers in their daily pricing decisions.

Unfortunately, the CURE bill is premised on exactly the opposite philosophy. Rather than encouraging the Commission to consider all factors bearing on the issue of competition, it builds its regulatory scheme on economic fictions by forbidding the Commission from considering such real world factors as intermodal competition, product and geographic competition, and the impact of lower cost imports in restraining rail rates.

Barring the consideration of intermodal competitive in competivie access cases would force the Commission to make real world decisions from a data base that could accurately be described as a fantasy world. Trucks provide the primary competition for railroads, and truck divertible traffic is among the most competitively priced. This provision would define shippers who do in fact benefit from strong truck-rail competition as captive—giving them both the protection of market competition and the shield of regulation. It creates remedies where there are no wrongs, based on artificial market definitions. No system of regulation can be predicated on such economic fictions, and this provision says a great deal about the philosophy behind the CURE proposal.

The same is true of the bill's provisions barring the Commission from considering evidence of product and geographic competition in market dominance cases. Product and geographic competition are real world factors that do impact on prices. Shippers and producers face competition in their markets from producers in other locations, and from substitute products. That competition is a real, limiting factor on the rates railroads can charge without losing the business altogether. Before the ICC, the railroads have made substantial concessions to shippers on this issue, accepting the burden of proof on both product and geographic competition, and tightening evidentiary standards. The American Paper Institute and NIT League have accepted that compromise—but the CURE group goes far beyond the position taken by the majority of shippers, and now seeks an arbitrary definition of competition that bars the Commission from even considering these factors, no matter how significant their impact might be in any real world situation. That is bad public policy.

Common sense suggests that we should be working to ensure that the Commission considers all factors present in real world markets. Anything less ensures a regulatory system based on economic fictions, a system that cannot function fairly or efficiently in a real world economic climate.

3. The bill would also amend the national rail transportation policy to direct that rail rates should be regulated in a way that enhances the competitive position of domestically produced coal and other shippers' goods in domestic and export markets. That is the kind of social policy goal that regulation forced the railroad system to carry for so long. The experiences of the 1970's should have taught us that railroads cannot be required to bear the costs of cross-subsidizing other industries. The railroads cannot survive under policies; the transportation system cannot afford it, and the nation cannot afford it.

4. Restricting the Commission's exemption powers, as proposed in Section 8, would force regulation on what by definition are the most competitive commodities moving by rail. Had this provision been in effect over the past 10 years, it would likely have barred the exemptions for intermodal traffic and perishables, widely regarded as among the most successful actions taken by the Commission in this decade. These exemptions are the principal reason for increased railroad participation (and thus increased shipper options) in these movements.

5. The competitive access provisions of the CURE Bill (Section 9) mandate rate equalization between competing routes—a disastrous practice that is widely (and correctly) blamed for driving pre-Staggers prices up to the level required to support the least efficient carrier in any market.

The history of pre-Staggers ratemaking illustrates clearly and persuasively that when rates are equalized, they will inevitably be set at the level needed to support the least efficient competitor in the market, no matter how the equalization formula is constructed. That practical experience is consistent with simple logic. While one can force carriers to establish "competitive" routings through joint or proportional rates, the reality is that one route will almost always be more efficient than the other. The more efficient route (often a single-line route) can always underprice its competition and attract the traffic unless rates are equalized. But if rates are equalized, it is self-evident that they cannot be equalized at the level of the most efficient route; that would drive the "competing route" out of the market. They will inevitably be equalized at the level needed to support the least efficient carrier in every market. This is exactly what happened pre-Staggers. It's difficult to believe that CURE is seriously proposing to reinstate it.

The provision will hurt shippers in at least two ways:

Much of the railroads' ability to reduce prices stems from their ability to lower costs, due to efficiencies generated when carriers became free to focus their traffic on the most efficient lines. By eliminating that efficiency, and forcing the reopening of less efficient alternative routes, the provision will make railroads generally less efficient, and force unit costs higher. That is a powerful counterbalance to any advantage that might come from increased competition.

Rate equalization will rarely lower prices, and it will generally raise prices where the new "competing" route is less efficient than the existing route (as it will almost always be).

Rate equalization was a bad practice, and shippers gained substantially from its elimination. But note that while rate equalization would negate most, if not all, of the shipper benefits derived from the CURE bill's competitive access provisions, those provisions cannot function at all without it.

6. Section 4 requires the Commission to reassess its maximum rate guidelines, and develop guidelines that link pricing to the actual cost of service.

This language goes to the heart of differential pricing—the fundamental concept underlying Staggers Act ratemaking, and the greatest single factor in the railroads' financial recovery.

The Staggers Act allows prices to fluctuate without regulatory review within a zone of presumed reasonableness, in response to competitive conditions. Prices above or below that zone are subject to regulatory review, with their reasonableness determined by all relevant factors. This permits carriers to maximize potential volume (by carrying all commodities that generate a return greater than the cost of operation), lowering unit costs for all shippers, competitive or captive.

"Developing guidelines that link pricing to the actual cost of service" can only mean an attack on the carriers' ability to price differently. While this might force some prices that are reasonable, but above the ICC's 180 percent threshold, down to the 180 percent level, that would inevitably require the railroads to raise prices charged shippers at the lower end of the zone to compensate. At best, this generates no net gain to shippers, simply a trade-off that would work to the serious disadvantage of highly competitive shippers such as grain and lumber shippers. More likely, however, higher prices for these very competitive commodities would drive them off the rails, raising unit costs for all shippers including captive shippers. The bottom line is that shippers with reasonable rates at the higher end of the spectrum gain substantially from the fact that shippers at the lower end can utilize railroad service. This broadening of railroad volume enables carriers to spread their costs across more units, generating price benefits for all shippers. Abandoning differential pricing for a cost based system would likely force up rates charged to all shippers, even those in the higher end of the range.

So far we've spoken only of shippers. To give some quantification of the impact this could have on carriers, note that if railroad prices had been capped at 180 percent revenue/variable cost in 1985 (not a radical hypothesis, since this is the upper limit of the zone of presumed reasonableness), the industry nationwide would have lost $1.5 billion in revenues.

7. The CURE bill would change the method of calculating a railroad's rate of return for revenue adequacy purposes by requiring the ICC to deduct, from their investment base, any "write ups" of track values made at the time the industry switched from betterment to depreciation accounting.

While this is a complex issue, it is a terribly important one, because the CURE proposal would unfairly and arbitrarily deny the railroads the ability to include millions of dollars in track and equipment investments made prior to 1983 in their rate bases—and by doing so, weaken their ability to finance replacement investments. The impact of that on railroad capitalized maintenance should be evident.

For decades, the railroads operated under the betterment system of accounting. That system prevented railroads from depreciating their initial investment in track, roadbeds and infrastructure. They were, however, allowed to expense replacement investment. When the railroads switched to depreciation accounting after the 1981 Tax Reform Act, the ICC allowed them to "write-up" the value of undepreciated track assets being carried on their books to the level they would have been had the railroads been using depreciation accounting—the cost at the time of last replacement, reduced by the amount of straight line depreciation since that time. The written up value is now being depreciated through the remaining life of the assets. The purpose of this transition rule was to prevent the shift from betterment accounting to depreciation accounting from denying railroads of millions of dollars in investments. The CURE bill, in Section 7, takes exactly the opposite approach barring the railroads from including these assets in the calculations underlying revenue adequacy determinations.

It's difficult to understand what policy argument could possibly drive this proposal. The carriers have made substantial investments in these assets, investments that have inured to the benefit of their shippers. But they are assests which have generated little or no recovery through depreciation. There is no "double dip" here, as CURE contends. The initial investment of these assets had to be carried on railroad books, sometimes for decades, without any depreciation recapture. The expensing of the replacement asset was the first chance the carriers had to recoup their initial investments. However, that still left the carriers with one full set of undepreciated and undepreciable investments sitting frozen in their investment base. The ICC accounting procedures properly give carriers the ability to depreciate that undepreciated, frozen base. The CURE proposal takes the opposite approach, and would perpetually exclude millions of dollars in investment from the carriers' rate bases in revenue adequacy calculations. This is another example of the bills' insistence on building regulatory structures on economic fictions. And it would cut into the cash flow necessary to support current or replacement investments, doing particular damage to carriers in the upper midwest—the Burlington Northern and Chicago and North Western—which invested heavily in track rehabilitation prior to 1983. It is a special, punitive proposal that treats railroads differently than anyone else in the economy. The real loser will be the shipper who depend on carriers' ability to maintain their capital investment levels, and keep their track and equipment at the state-of-the-art.

8. Under the the Staggers Act, the ICC must make a yearly determination of the state of each railroad's finances. Section 7 of the CURE bill would require the ICC to make an additional assessment—not just what the railroad did earn, but what it should have earned and what it should have spent. The Commission would have to mount an investigation of railroad management efficiency, to decide if every rate on every railroad is set at the maximum level possible. Bear in mind that this covers all rates on all traffic, not just moves from captive shippers. This provision is far more intrusive than any form of rate regulation ever exercised by the ICC. It would require an avalanche of paperwork by the railroads, as they sought to prove that all of their hundreds of thousands of rates were set at the level that met competition but maximized profits. And if would immerse the ICC even further in the morass of regulatory delay, as it tried to sort out charges and countercharges by shippers, each trying to convince the Commission that its rates were too high because everyone else's were too low. Issues of this type cannot be resolved with mathematical certaintly, and the Commission is ill-equipped to retroactively critique every aspect of every railroad's marketing operation. It is inconceivable that the Commission could even digest the data in any reasonable period of time.

But the worst aspect of this provision is that it would require the ICC to second-quest the railroad's investments, costs, and individual rate decisions, months—perhaps years—after day-to-day fluctuations of the marketplace demanded a response. ICC practitioners and attorneys would again become the carriers' marketing department, setting rates to appease the ICC, not to meet competition and fill shippers' needs.

9. Section 4 of the CURE bill would shift the burden of proof in rate reasonableness cases from the complaining shipper to the defendant railroad. This goes beyond reversing the Staggers Act, and actually tightens the pre-Staggers regulatory scheme which placed the burden of proof on the complaining shipper. This is nothing unusual; the basic premise of our civil and administrative legal system requires the complaining party to bear the burden of providing his case. That requirement rests on principles of simple fairness, and on the recognition that removing that burden from the complaining party or shipper creates a powerful incentive to sue.

The CURE proposal is a radical departure from that historic framework for civil and administrative litigation. Railroads would be presumed guilty of abuse every time a rate is set high enough to come under the ICC's jurisdiction. Instead of the annual 30 to 40 rate complaints filed at the Commission, shippers would have every incentive to file countless charges, since they would be required to do no more than state their allegation, and then sit back and see how well the carrier could defend its rate. No system of law or regulation can operate this way.

This provision is the another part of the CURE bill that would result in more, not less, regulation and regulatory delay. Moreover, it purports to address a problem that doesn't exist. Shippers can and do win these cases at the Commission, as demonstrated in numerous decisions over the past few years on grain, coal and other commodities. Along with the other parts of the CURE bill, Section 4 would significantly discourage rates above the regulatory threshold, making it more and more difficult for the railraods to price differentially to meet competition and attract traffic.

It's important to recognize that the world has changed enormously in the past 8 years, and we can never recreate the competitive relationship between truck and rail that existed before the passage of the Staggers Act. The trucking industry has also been partially deregulated, and there are no serious efforts to alter its status. If anything, the trucking industry is likely to be further deregulated in the years ahead. We know from experience that it is already very difficult for a regulated railroad industry to compete effectively with a regulated trucking industry. How then could one reasonably expect a more regulated railroad industry to survive in competition with a deregulated trucking competitor? The answer is that it could not survive, and the various proposals to tighten railroad regulation must be viewed against the recognition that unlike the pre-Staggers era, the railroads primary competitiors are and will continue to be deregulated.

Those who participated in the adoption of the Staggers Act reforms have received well deserved credit for their accomplishment. We are not the stewards of those accomplishments, and the manner in which we address the issues raised at this hearing will have as much impact of the 1990's as the decisions made by this Committee in 1980 have had in the past 7 years.

Senator EXON. The Honorable Ashley Brown, Commissioner Ohio Public Utilities Commission, on behalf of the National Association of Regulatory Utility Commissioners; and Mr. Steven W. Hamm, Electric Committee Chairman of the National Association of State Utility Consumer Advocates. Will you please come forward, gentlemen, and we will proceed with your testimony.

Welcome, Mr. Brown, and welcome, Mr. Hamm. Since I have no other instructions or requests, we will start out in alphabetical order with the first witness on my list, Mr. Brown.

STATEMENT OF ASHLEY BROWN, COMMISSIONER, OHIO PUBLIC UTILITIES COMMISSION, ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS, ACCOMPANIED BY JOHN M. FLUMERFELT, DIRECTOR, CONGRESSIONAL RELATIONS

Mr. Brown. Thank you, Mr. Chairman, and Members of the subcommittee.

We appreciate the opportunity to appear before you today. My name is Ashley C. Brown, and I am one of the five commissioners of the Ohio Public Utilities Commission, and I am a member of the Electricity Committee of the National Association of Regulatory Utility Commissioners, NARUC.

And I appear on behalf of NARUC today, and accompanying me to my left is John Flumerfelt, who is NARUC's director of congressional relations.

With respect to these proceedings, I appear both as an experienced regulator, and as a representative of electric ratepayers nationwide.

Ratepayers are directly affected by the ICC's implementation of the Staggers Act, because the rate that a utility pays to transport its coal is not an item on which a company earns a return, but is in fact a cost paid directly—passed through the company from the customers to the ratepayers.

So the costs that come out of the ICC's decision-making process or nondecision-making process are ratepayers 'costs.

Regulatory commissioners throughout the United States are essentially performing the same function that the ICC theoretically is supposed to be performing.

One of the great challenges that we face is balancing fully competitive, partially competitive, and monopolistic circumstances, and trying to draw a delicate balance.

It is on the effort to draw that balance in the view of NARUC, the ICC has been a failure.

We feel that the ICC has simply not done the proper balancing in regard to captive shippers. It has interpreted the principles of the Staggers Act and exercised its discretion in a manner that entirely tips the scales in favor of the railroads.

Little, if any, effective relief is available for shippers who feel they are subject to unreasonable rates.

I might note, the most effective relief seems to be the scheduling of congressional hearings, which seems to free up the ICC to make decisions.

In fact, an ICC rate reasonableness proceeding is so burdensome, and the chance of success so slim, that few parties really want to enter into the ordeal.

And I think Senator Melcher had an excellent idea in giving an example of that.

Our criticisms of the ICC were fully set out in the prepared testimony that has been filed, so today, I would really like to focus on two areas.

One is what I believe to be the most significant factor in preventing a shipper from obtaining relief during an ICC Proceeding; and the second is the absence of any effective protection whatsoever of State and local concerns.

The obstacle I have in mind is the burden of proof that lies in the shipper. The initial burden of proof under Staggers lies with the supplier—excuse me. The initial burden of proof in an ordinary rate case lies with the supplier of the goods or services.

This is exactly as it should be. It is completely unrealistic to expect, as the ICC does, that a consumer, who has little or no access to a supplier's files, provide an analysis that is comprehensive enough to convince a court or a regulatory body that its complaint is just.

In fact, by placing a burden on the shipper, all proceedings are highly dependent on a very, very cumbersome discovery process, which have the effect of not only delaying cases; they also have the effect of effectively deterring cases.

It is not valid to assume that a captive shipper is able to prove that a rate is unreasonable, considering the limited economic resources, relative to the railroads, and its limited access to the railroad's documentation of its rate.

When you combine the burden of proof with what has to be proven, it is no wonder that so few parties have obtained relief, or for that matter, that there have not been more cases; because the facts justify more cases than have been filed.

Now, let me point out that we do not argue that the railroads should be treated exactly as any other regulated entity should be. Because for all intents and purposes we think that Staggers in many ways, and certainly for noncaptives, has been a success.

We do not propose that the railroads be reregulated. It is our view that Staggers was an excellent piece of legislation, and for the noncaptive shippers and for the railroads, it has worked very well.

We are not calling for reregulation of the railroads, nor would anything be taken away from them except the ability to avoid regulatory scrutiny in a monopoly circumstance.

The safeguard against abuse of monopoly opportunity was clearly written into the Staggers Act, and it is unfortunate that the ICC has chosen simply to neglect it.

No one would argue that the opportunity for monopolistic pricing of rail rates would exist in a regulatory environment. The only relief for shippers, subject to monopolist rates, is an equitable and an objective regulatory process.

Now, we do not claim, also, that all captive shipper rates are unreasonable. All we are suggesting is that there be a legitimate process for review for those shippers who feel they have been abused by the rates that they are being charged.

A shipper is only likely to pay what he feels is an unreasonable rate, only for so long, before either economic circumstances catch up with him or her, or they switch their line of business.

In the case of a utility, the transportation rate for coal—the transportation rate paid for coal plays an integral role in the decision of whether or not to invest in further coal-fired generation; and importantly, is an important factor in whether the utility's own rates are in fact competitive.

In fact, the railroad itself is infinitely better off when its customers are prospering.

I could go into, Mr. Chairman, the local concerns. But I see the red light is on, if you wish me to stop.

Senator EXON. Well, Mr. Brown, we are much interested in your testimony. I would simply say at this time that we accept your prepared statement as a part of the record.

Also the statements submitted for the record by the preceding and following witnesses.

If you can go ahead and wind up your oral testimony in the next two or three minutes, we would be glad to indulge you for that time because your testimony is very important.

Mr. BROWN. Thank you, Mr. Chairman, and I think I can do that.

NARUC is concerned about the issue of State certification, and that States and localities be adequately in ICC processes.

As you know, Mr. Chairman, Senator Rockefeller, the ICC, in order for a State to exercise rate jurisdiction, it can only be done under certification from the ICC.

And I would point out that among other onerous conditions the ICC applies is, it requires States to decide cases in, I forget whether it is a 60 or a 90-day timeframe. And I would contrast that with the 7-year timeframe that the McCarty Farms case has taken, and some longer cases at the ICC.

States simply cannot regulate under existing conditions. It is our view that the ICC policy and legal obligations can be fulfilled if in fact it operates as an appellate body reviewing State decisions, rather than requiring prior certification.

Secondly, I would note that the ICC needs to hold local hearings when it comes to abandonment, if the local communities desire that. And I think the ICC has been profoundly deaf to local concerns.

In Ohio we have seen, since 1980, the abandonment of 1,200 of 7,000 miles of rail lines in the State of Ohio without a single local hearing. And I think local concerns need to be made at the highest levels of the ICC, and local hearings would do that.

And I thank you, Mr. Chairman, for giving me a slight extension to make those points.

[The statement and questions and answers follow:]

STATEMENT OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

This prepared testimony is submitted for the hearing record by the National Association of Regulatory Utility Commissioners (NARUC) as a supplement to the oral presentation of its witness, The Honorable Ashley C. Brown, Commissioner of the Ohio Public Utilities Commission and member of the NARUC Committee on Electricity.

The NARUC is a quasi-governmental, non-profit organization founded in 1889. Within our membership are the governmental agencies of the fifty States, the District of Columbia, Puerto Rico and the Virgin Islands engaged in the regulation of utilities and carriers. Our chief objective is to serve the public interest by seeking to improve the quality and effectiveness of regulation.

INTRODUCTION

NARUC has been on record for a number of years criticizing the Interstate Commerce Commission's implementation of the Staggers Act. After repeatedly endeavoring to seek changes in what we feel are totally flawed principles and procedures adopted at the ICC, we have turned to Congress as the only avenue to achieving moderate changes in the implementation of the revenue adequacy, rate reasonableness and intrastate rate provisions of the Staggers Act.

As a starting point, we stress that regulatory commissioners throughout the nation perform essentially the same functions as the ICC does with respect to captive shippers under the provisions of the Staggers Act. We are charged with balancing the needs of the companies subject to our jurisdiction to achieve and maintain financial health with the needs of consumers to have service provided at reasonable rates.

In many instances the industries subject to our jurisdiction (including electric, gas, telephone, water and transportation industries), like the railroads, engage in a mixture of fully competitive, partially competitive and fully monopolized lines of business. Some, like the railroads, are organized in holding companies.

We feel that we have dealt with these emerging, complex situations in a sensible manner that continues to strike a balance between supplier and consumer interests. We also believe that the ICC has not done so. It has interpreted the principles of the Staggers Act and exercised its discretion in a manner that tips the scales entirely, and unfairly, in favor of railroads.

Our testimony today compares commonly accepted ratemaking principles used by State regulators in these complex situations with the ICC's regulatory implementation of the Staggers Act, specifically with regard to ratemaking standards concerning monopoly rail rates. The following two points are stressed:

(1) *The NARUC supports legislation, such as S. 676, to amend the Staggers Rail Act so as to prevent unreasonable abuses of monopolistic pricing opportunities.*—As regulators of utilities, and thereby representatives of ratepayers nationwide, we are keenly interested in the prices utilities pay to transport coal. Transportation costs are *not* an item on which a utility earns a profit, but are incurred at the direct expense of the ratepayer. We are convinced that the market power to impose unreasonable transportation rates on "captive shippers" exists, and that the ICC's regulatory procedures offer little or no relief.

The ICC has adopted a regulatory program concerning monopoly rail service and the allocation of the revenue burden between monopoly and more competitive services which no State regulatory commission would employ in regulating the rates of utilities operating in similar situations. State regulation of utilities and carriers, based upon decades of experience, is fundamentally designed to insure quality of service and affordability of rates, but ICC procedure deviates so far from well-established regulatory principles that, as a practical matter, little or no relief is available to captive shippers who may suffer from unreasonable rates.

(2) *The NARUC is strongly opposed to unwarranted Federal preemption of State authority to regulate intra*state rail matters, and advocates the repeal of the State certification requirement contained in the Staggers Act.—The public interest is best served when decisions materially affecting the quality of citizens' lives are made by officials who are easily accessible to those citizens. Regulatory decisions based on situation specific conditions balance the interests of competing parties and enhance economic efficiency. The appropriate Federal role in intrastate ratemaking, if any, is through appellate review of those decisions. It is unprecedented for the Federal government to regulate intrastate rates.

DISCUSSION

Athough competition is the ideal economic operating principle from the perspective of the consumer (in this case, the rail shipper), regulatory oversight is necessary in situations in which competition neither exists nor is practical. In deregulating the nation's railroads, the Staggers Act contemplated an efficient balance by providing regulatory relief for shippers who were subject to monopolistic pricing. The ICC's regulatory interpretation of Staggers, however, is startling and unorthodox, and allows rail earnings above reasonable levels. This appears to be in direct contradiction of the intent of Congress in formulating the statute.

The Staggers Act recognizes that a certain amount of differential pricing is necessary to insure a railroad's vitality, and this principle is generally accepted by railroad customers. Unfortunately, the ICC's implementation of the Act allows railroads to shift an overwhelming and inequitable degree of their fixed costs onto their captive shippers.

REVENUE ADEQUACY

The cost of capital

The concept of "revenue adequacy", (or "revenue requirement" in the realm of utility ratemaking) provides a standard by which to judge system-wide rate levels. The ICC, however, uses a formula for determining revenue adequacy which is questionable and may profoundly overstate a railroad's actual revenue needs, thereby justifying excessive rates.

In determining a railroad's revenue needs, the ICC deviates from several well-established regulatory practices. Although the current cost of capital is a legitimate target for the revenue requirement, the ICC has erred grossly in setting that target.

First, the equity portion must be determined in relationship to reasonable returns earned by companies of similar risk. To ascertain what companies are of similar risk and what they are earning, regulators frequently examine many financial indicators. Because the ICC has failed to engage in this basic process to ascertain a reasonable target return on equity, it has set an extremely high target since the passage of the Staggers Act. When the ICC examined multiple financial indicators in 1980, before passage of the Act, it found a number of railroads to be revenue adequate—a conclusion that seems much more consistent with their apparent financial reality.

Second, the ICC calculates a current cost of debt, and then applies this figure to the railroad industry as a whole. In calculating a utility's cost of capital, State commissions use the actual cost (i.e. interest rates) of embedded debt, for each utility it regulates.

Although the costs of emedded debt are readily determinable, the ICC calculates the railroads' cost of debt on the basis of current rates, which serves to overstate actual costs. State regulators recognize that cost of capital is situation specific, i.e. that the debt component of a utility's cost of capital is based on interest rates which apply as of the time that the debt is contracted.

The investment base

Another way the ICC allows railroads to overstate their revenue requirement is through misstatement of the investment base. In the past, because of the use of railroad betterment (RRB) accounting, certain expenditures incurred in the replacement of track structure accounts were expensed against current income, rather than being capitalized. When the ICC switched to depreciation accounting, it allowed the railroads to capitalize some items that had already been expensed. This regulatory environment has given the railroads a potential double recovery of costs. The extent to which there has been a double recovery will vary from railroad to railroad, but there is little doubt that railroads with large positive incomes recovered those costs in the past, while their inclusion in the current revenue adequacy test unfairly inflates the estimate of their revenue needs.

Whatever the extent to which these charges are true, the important fact remains that the ICC has failed to protect the public interest by not adequately scrutinizing a railroad's investment base.

State regulators, on the other hand, consistently use standard original cost depreciation accounting, where an investment is amortized in rate base over its useful life, and assets which have been previously expensed are eliminated from the rate base. A utility's investment base is also under regular scrutiny relative to a "used and useful" standard.

Moreover, in almost any other State or Federal regulatory proceeding, any investment made by a regulated entity which is proposed to be included in rate base must be ascertained to be prudent. In the case of the railroads, however, there is no standard of prudence, other than the Long-Cannon factors, which offer no realistic means of relief to the shipper.

Capital structure

Finally, in determining the overall cost of rail capital, the ICC currently assumes an industry average debt-equity ratio of 29:69. Not only does this invole a much smaller share of debt than utilities, which are generally in the range of 50:50, it is even less than many corporations which are involved in fully competitive businesses. As equity is more expensive than debt, the ICC's ratio also serves to establish a higher threshold for revenue adequacy.

It is worth noting that ICC Commissioner Lamboley has expressed many of these same criticisms. In his May 15, 1987 Dissent in Ex Parte No. 393 (Sub-No. 1), "Standared For Railroad Revenue Adequacy", the Commissioner advocates the use of multiple factors in the determination of revenue adequacy, rather than capital cost alone, and the use of embedded cost of debt in determining cost of capital. He also notes that revenue adequacy should include the results of rail-related affiliates. Finally, he states, "we should not, indeed cannot, responsibly defer or avoid re-examining for ourselves that which we have determined and now acknowledge as flawed." *May 15 Dissent at 10.*

In summary, the ICC has erred in its handling of the cost, amount and structure of capital. It should also be pointed out that the fundamental principle in establishing the revenue requirement is to provide the regulated entity the opportunity—not a guarantee—to earn a return on investment equal to that earned by entities of similar risk. The word opportunity must be stressed because the ICC seems to have mistaken this most fundamental of all regulatory principles in regard to State regulation of utilities, as evidenced by the testimony of ICC Chairman Gradison during this year's House hearings on Staggers. There are no guaranteed rates of return for utilities—if there were, then there would be no risk and the return on equity would be set without a risk premium—there are only reasonable opportunities to earn fair rates of return that are commensurate with the risk faced by the regulated entity.

Many utilities fall short of their authorized rate of return for a variety of reasons—a change in economic conditions, management mistakes—even for sustained periods of time. Public utility commissions do not, in fact cannot, retroactively attempt to make utilities whole. They can only provide an opportunity on a going forward basis to earn a reasonable rate of return.

RATE REASONABLENESS

Burden of proof

The most onerous aspect of the ICC's implementation of the Staggers Act is that the burden of proof lies with the complaining party in a rate complaint case. In effect, there is no relief available. The fact that a very small number of parties have now won ICC rate cases is remarkable, and represents an almost incredible exception, rather than the rule.

It is extremely uncommon in Federal or State regulatory proceedings that the burden of proof is on any party other than the supplier of the regulated goods or services. This is as it should be, with the ICC being a notable exception. It is completely unrealistic to expect the purchasing party to be able to prove a rate is unreasonable, especially when the party, in this case the captive shipper, has limited resources compared to the railroad and limited access to the railroad's documentation and justification for the rate.

Shifting the burden of proof in the context of the Staggers Act would still provide railroads with considerably more lenient treatment than other regulated entities receive. The railroads would continue to collect rates while their reasonableness is being evaluated.

Options for relief

The limited options given to the shipper to prove that a rate is unreasonable further inhibit any opportunity to obtain relief. The shipper can 1) try to prove a railroad is revenue adequate, contrary to the ICC's consistent determination that it is not, or 2) try to prove that the rate is excessive due to management inefficiency by analyzing an entire railroad using the Long-Cannon factors, or 3) try to prove that it would be cheaper to build his own "stand alone" railroad.

The ICC, of course, has never found a railroad to be revenue adequate, notwithstanding appearances that several railroads may, in fact, be flourishing. It is extremely unlikely that a shipper would have the resources to prove not only that the ICC was wrong in its annual revenue adequacy determination, but that the railroad had so much excess revenue that the rate in question was unreasonable.

In assessing management inefficiency, the Long-Cannon factors are applied to a railroad's overall operations, and the shipper must prove that elimination of the identified inefficiencies would then render the railroad revenue adequate. Few, if any, parties would have the resources necessary to analyze the entire operations of a railroad in this detail, just as few, if any, ratepayers could be expected to bear the burden of proof in filing a rate case against their local utility.

Moreover, it is unfortunate that the ICC uses the Long-Cannon factors (and then, ineffectively) only during the complaint process. In our view, it would also be appropriate to apply them as a form of prudency review during the ICC's revenue adequacy proceedings.

The concept of stand-alone cost essentially means that no rail rate is too high if it is less than the cost (on a per ton basis) of serving an individual shipper or group of shippers as if they were isolated from other rail consumers. In its purest form, this would mean that a railroad can charge a utility any rate it wants as long as the rate is less than it would cost the utility to build its own railroad, including rights-of-way, track, bridges, etc.

This, unfortunately, is the only realistic option by which to pursue an ICC rate complaint, and the only basis on which relief has been given (although the decisions have been appealed by the railroads).

The concept of stand-alone cost as a maximum rate is completely foreign to any other area of ratemaking and ignores the fact that complete railroad systems are not built to serve any one customer, but operate as integrated entities, with their fixed costs shared among all customers (although with a disproportionate share thrust upon the captive shippers).

Also unlike a rate proceeding before a State utility commission, the ICC does not consider the actual cost the railroad incurs in supplying a service to the shipper. The actual cost of a particular service is equally as important in determining rate reasonableness as any other cost, real or hypothetical, that the railroad has incurred or the ICC has conjured up.

PREEMPTION OF STATE AUTHORITY

Certification requirements

The NARUC is strongly opposed to unwarranted Federal preemption of State authority to regulate intrastate rail matters, and advocates repeal of the State certification requirement contained in the Staggers Act, leaving the ICC free to engage in appellate review of State intrastate ratemaking decisions.

Section 214 of the Act requires each State commission wishing to exercise juridiction over intrastate rail rates to be certified by the ICC. Following enactment of the Act, forty States immediately filed requests for certification, but it took five years for the ICC to grant the majority of those States permanent certification.

This requirement is seriously flawed due to the absence of any Federal guidelines to facilitate the development of reasonable and clearly articulated certification standards by the ICC. Absence of such standards confuses the degree of permissible discretion States are allowed in intrastate rail ratemaking. Moreover, it allows the ICC to abuse the certification requirement.

The States have played an historic role in regulating rail rates, and intrastate traffic patterns in each State are unique. By encouraging meaningful State consideration of intrastate rate cases, consumers and small shippers will be assured an opportunity to be heard in a local forum best situated to determine the uniquely local needs of both carriers and shippers.

Morever, certification fails to effectuate Congress' intent to preserve the State role in promoting federally conforming intrastate rail regulation. If repealed, friction between the ICC and the States could be reduced dramatically while preserving fundamental principles of federalism. In addition, States would be free to develop innovative procedures and standards for intrastate rail rate regulation consistent with Federal requirements from which the ICC and the nation as a whole could benefit.

Standard of review

The NARUC is also concerned with the standard of review employed by the ICC for review of State rail rate decisions. Under well-established principles of administrative law, the standard of review applicable to agency proceedings, unless clearly articulated by statute, is limited to the appellate function, where deference is granted to agency expertise. Here, although the ICC possesses expertise regarding the regulation of rail rates, each State authority possesses a unique expertise concerning intrastate rail traffic patterns.

The ICC should apply to its review of State rail regulation the deferential standard of review applicable to appellate review of ICC decisions. Unless Congress wants wholesale preemption of the State role in these matters, it should limit ICC review to the appellate function.

Accordingly, the ICC should be bound by the State agency's factual decisions as long as there is substantial evidence in the record. State conclusions of law regarding the application of Federal standards to the facts should be upheld unless clearly erroneous. State procedural decision-making should be upheld unless arbitrary and capricious. Thus, the ICC should restrict its scope of review to that set forth in the Administrative Procedure Act, 5 U.S.C. 706.

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July 17, 1987

The Honorable Ernest F. Hollings, Chairman
Committee on Commerce, Science and Transportation
United States Senate
Washington, D.C. 20510-6125

Dear Senator Hollings:

I am in receipt of your letter dated July 6, 1987, concerning follow-up questions to my testimony at the Surface Transportation Subcommittee's June 24 rail industry hearing. I greatly enjoyed being able to appear before Senator Exon's Subcommittee and I appreciate this opportunity to answer your additional questions.

The questions and respective answers appear below:

Questions from Senator Hollings:

1. The railroads have testified that coal rates have declined since the passage of the Staggers Act and that most coal shipments now move under contract. How have these factors affected the prices utilities pay to transport coal?

The passage of the Staggers Act has produced obvious benefits which are being enjoyed by consumers nationwide. It is our view that a competitive economic environment, when it exists, can be the most effective means of ensuring high quality, low cost services to the ultimate consumer. That is a public policy judgement as to the best means of achieving efficiency and equity. It is, however, a judgement that must be made in context. It is important to realize that in situations which are entirely non-competitive, as is the case with captive shippers, there will always exist the opportunity for monopolistic (i.e. abusive) pricing practices. It was with this in mind that Congress designed the Act so as to provide a mechanism of regulatory relief for shippers who do not benefit from, and in fact may grossly subsidize, the competitive side of a railroad's business.

It should also be noted that, absent reliable market and cost of service date -- and the railroads' are not readily willing to part with such -- the trend they cite in coal rates is both meaningless and out of context. The relevant question is whether the rates charged captive coal shippers are reflective of cost of service and consistent with what they would be in a more competitive setting. On further note is that NARUC has never maintained that the rates charged captive shippers of coal are per se unreasonable, but only that when a captive shipper has reason to believe he is the victim of the abuse of monopoly pricing power that he is entitled to a fair hearing on his grievance before the ICC.

2. In the Association of American Railroad's written testimony, electric utilities were considered on average, twice as profitable as railroads. What are your views on this?

If this is true, and we neither have the data the AAR utilized nor its methodology, it would seem to indicate that equitable regulation is not an undue burden on an industry's ability to earn profits, especially if the regulation effectively creates incentives for the industry to operate efficiently. I would note, however, that if the AAR bases its assertion on the ICC revenue adequacy methodology, this would significantly lessen its accuracy.

The question, however, seems irrelevant to this debate. Utility profits are unaffected by coal transportation rates, as these rates are passed directly through to the utility's ratepayers with no profit earned thereon. The NARUC would not endorse the CURE legislation if it was our view that it would simply enrich utility investors; rather, it is our view that it will benefit the electric ratepayer.

3. In your testimony, you both compare the utility rate making process to that used by the Interstate Commerce Committee [sic] (ICC) to determine the railroads [sic] revenue requirement or revenue adequacy test. You contend that there are procedural and substantive flaws in the ICC's process. Given the claims that 75-90% of the railroad's [sic] business is competitive, what differences do you think should exist, if any, between regulating utilities and the railroad industry?

Again, where competition is working for the railroads and the shippers, this is in the public interest. Similarly, we are currently seeing increasing levels of competition in the telephone, natural gas and electric utility industries, which also provide economic benefits to the nation's consumers. We do not, therefore, wish to re-regulate the railroads; we are concerned only with the lack of accountability, due to an absence of effective regulatory review, for that aspect of a railroad's business which does not enjoy the checks and balances which automatically accrue in a competitive environment.

The real challenge for regulators today is identifying the captive and competitive customers and developing policies appropriate for each. Rather then taking such a measured approach, the ICC has effectively determined, ipso facto, that all shippers are in a competitive situation. Such a judgement is more a reflection of ideological bias than reasoned economic analysis.

In our view, the hearing record clearly demonstrates that the accounting procedures used by the ICC serve to overstate a railroad's revenue requirements. Why use hypothetical values and industry averages when actual values and company-specific data are readily available? To ascertain the current financial health of the railroad industry one only needs to look at the data. The ICC's methods are divorced from reality and serve to protect the railroads, rather than the captive shippers to whom the Commission is statutorily obligated. The use of principles commonly accepted by utility regulators would serve to ameliorate this problem.

4. In further analyzing Section 7 of the Consumer Rail Equity Act, the ICC notes that "the bill would force a departure from the Commission's existing practice of using discounted cash flow as the appraisal mechanism, despite the fact that discounted cash flow is the methodology preferred by the majority of state public utility Commissions." Please respond to this, if possible.

First, let me note that there are certain perceived problems with discounted cash flow (DCF) when it is used exclusively. However, I know of no reason why Section 7 of the CURE bill would force a departure from the existing practice of using DCF analysis to help determine the cost of equity capital. Many regulatory commissions, including the FERC, use DCF analysis, but they regularly supplement this analysis with other information to help determine the cost of equity for individual regulated companies. Section 7 would simply require the ICC to follow the same practice.

Even if the ICC's estimated cost of equity were similar to that found by other regulatory commissions, the total cost of capital determined by the ICC would be far higher. This occurs in large part because the ICC allows a far greater amount of high-cost equity in the railroads' capital structure than other commissions generally allow. This, together with the use of high-cost and hypothetical current cost of debt standard, significantly inflates the determination of the railroad cost of capital.

4. In its analysis of the Consumer Rail Equity Act, the ICC has stated that Section 7 requires a "mixing [of] asset levels

derived from betterment accounting with earnings predicated on depreciation accounting [which] is not consistent with the sponsor's stated desire for traditional public utility practice, but is contrary to such practice." Please respond to this, if possible.

Although I am not an accountant, much less an expert on the intricacies of railroad accounting procedures, my reading of Section 7 indicates that it explicitly provides for the use of depreciation accounting for all purposes in the determination of revenue adequacy. This is, therefore, consistent with public utility commission practice. As I understand it, until recently the railroads applied a different accounting practice, i.e. RRB accounting, for track structure. The transition from one accounting system to another inevitably raises difficult problems, but should not be an excuse to inflate the determination of a company's revenue requirement.

Questions from Senator Danforth:

1. Section 11 of the CURE bill changes the standard for state regulation of intrastate rates. Under Staggers, the states must regulate "exclusively in accordance" with federal law. Under CURE, the states must regulate "consistently" with federal law. The railroads are concerned that this change, and other procedural modifications in Section 11, would mark a return to the days when regulatory lag resulted in the loss of hundreds of millions of dollars of revenue. What is the purpose for the proposed CURE modification?

We do not see any hidden meaning in the change from "exclusively in accordance with" to "consistently with". This appears merely to be a drafting change, without substantive intent, in order to conform to the word "inconsistent" in the following paragraph. Thus, States must continue to follow all applicable federal standards in regulating intrastate transactions, and the ICC will continue to be available to police States that deviate from those standards.

The railroads' concern about "regulatory lag" are ill-founded. The term refers to the inability of a regulated entity to collect a rate increase while a commission considers the validity or reasonableness of a rate. The Staggers Act was careful to entirely eliminate regulatory lag as a factor, and the CURE legislation would not change this. It is ironic that the railroads would think any delays caused by State regulation could possibly compare with the excruciating inability of the ICC to render a captive shipper rate reasonableness decision absent a series of Congressional hearings. Conversely, the ICC, I am sure, would waste no time in rendering a decision in a review proceeding involving the appeal of a State agency's decision. Compare this with the ICC's handling of McCarty Farms.

2. Do you believe uniformity in railroad rate regulation is important to the efficiency of our rail system? Do you think that dropping the requirement that a state certify its rate regulation follows federal law will hinder uniform rate regulation?

We believe in uniformity of rate regulation, providing some level of flexibility exists at the local level, and do not think that dropping the certification requirement would hinder uniformity of rate regulation. We strongly believe, however, that intrastate rail rate decisions should be based on local needs and conditions which are more readily discernable at the local level than in Washington. This is especially true in regard to abandonment issues and short line sales and service. Clearly, in the context of the national and international markets in which intrastate transportation occurs, uniformity is desirable.

3. Have you ever lowered a utility's rates knowing that, even with the higher rates, they would not earn the cost of capital? If so, in what percentage of your rate cases has this happened?

First, it must be clear that regulators do not guarantee that utilities will either earn or not earn their authorized rate of return; we merely give them an opportunity to do so. They may earn under, or over, the rate of return, depending on how efficiently their operation is run. Cost of capital is certainly a factor in determining an authorized rate of return, but the cost of capital is but one in a number of factors used for this purpose. Regulators look at the total financial picture of a utility and set a rate of return accordingly. Real values and company-specific data are used. The rate of return is then set so as to equitably balance the needs of a utility's ratepayers with the utility's investors.

Respectfully yours,

Ashley C. Brown Jr.

Ashley C. Brown, Commissioner
Public Utilites Commission
of Ohio

Senator EXON. Thank you very much. Mr. Hamm?

STATEMENT OF STEVEN W. HAMM, ELECTRIC COMMITTEE CHAIRMAN OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES, AND CONSUMER ADVOCATE, SOUTH CAROLINA DEPARTMENT OF CONSUMER AFFAIRS

Mr. HAMM. Mr. Chairman, I appreciate the opportunity to come. I reminded myself of a saying while I was sitting in the back of the room that the measure of a man is to hear some of the statements that are made, no matter how outrageous they might be, and determine if the individual is able to keep a straight face.

I was disappointed that I was in the back of the room and was unable to review the demeanor of some of the previous witnesses to determine if some of the statements, although sincerely stated, were accompanied with a straight face. I would be disappointed if they were.

What I would like to do is make a couple of observations as a State official in South Carolina responsible for representing the public.

I am the public's regulatory attorney in the State of South Carolina. I represent the public, not only in utility matters, I also represent them in insurance matters, and in addition to that, I am the credit administrator for the State of South Carolina.

I have personally participated in about $5 billion worth of rate cases, and would like to offer several observations on my experience in relation to the bill under consideration.

I would be in strong disagreement with the assertions made that the bill under consideration is the—is a precursor to drastic reregulation.

When you look at the existence of the Staggers Act of 1980, and the adjustments that are suggested in this bill, I would suggest that in fact it is consistent with congressional policy to outline clear public policy to those that it directs to enforce certain legislation.

Indeed, Congress may be subject to some criticism that it expected more out of the ICC with the broad discretion that was afforded to it; and under that broad discretion, the ICC has determined that certan action is inappropriate.

A couple of issues I think ought to be raised. I agree with the previous comments just made regarding the burden of proof. You are asking an impossible situation, and indeed, you are raising fundamental questions about what you want out of the ICC, and what you want out of the regulatory process, when those in control of the data are not the ones responsible for justifying the price.

In any State regulatory process, the regulators would be run out of the State if that kind of procedure was attempted to be followed on a State level. And indeed, it is not followed at any State level, which ought to raise some question that perhaps the 50 States have some semblance of collective wisdom.

Another issue I think that needs to be considered, and that is, the whole question of financial indicators. I was very interested to hear the earlier comment about 3.9 percent return, and would offer a caution, again, as one who has cross-examined many outside economists who were brought into the State of South Carolina to justify various returns for regulated utilities, I would suggest caution if not downright skepticism might be an appropriate response on the part of this committee.

Certainly the railroads are entitled to, under our constitutional provisions of regulation, and even our free market process to a reasonable return on their investment. The question is, on what numbers do you calculate some of those investments.

And I think you ought to have some concerns in terms of what that investment ought to be. I recently won a case that I personally argued in front of the South Carolina Supreme Court regarding what constitutes an inclusion in to a rate base.

And indeed, some of the activities allowed by the ICC would be clearly struck down by the South Carolina Supreme Court as not being consistent not only with law, but in fact, reasonable public policy; that in fact, investors earn a return only on those dollars they actually provided, and not more than once.

So it seems to me that ultimately the issue of whether or not how many complaints have been filed at the ICC ought to be addressed again.

The fact that various shippers have found the process to not be meaningful and exorbitantly expensive cannot then be used as a guide to say, well, since there have been relatively few proceedings filed, that means that the process is working.

I would strongly disagree that simply changes in the law would result in massive cases. It seems to me that the ICC commissioners have to enunciate and expound a clear and rational public policy in their statements.

Once the shippers and other parties are aware of those statements, and understand that they are going to be uniformly applied, there would not be need to have constant complaints to the ICC, because the ICC would have established a clear highway on which all would ride.

And I would conclude my comments. I have provided you with prefiled testimony, and I will not attempt to go over that in any detail this morning, Mr. Chairman.

[The statement and questions and answers follow:]

STATEMENT OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES AND SOUTH CAROLINA DEPARTMENT OF CONSUMER AFFAIRS

INTRODUCTION

Thank you for providing us an opportunity to present our position on an important bill, S. 676 (H.R. 1393)—the Consumer Rail Equity Act. The National Association of State Utility Consumer Advocates (NASUCA) is a national organization composed of officials in 37 states and the District of Columbia, who are directed by law to represent the interests of consumers of regulated public utility services before regulatory commissions. The South Carolina Department of Consumer Affairs ("Department") is an agency of the State of South Carolina and a member of NASUCA. The Consumer Advocate and Division of Consumer Advocacy within the Department have been created to protect the interests of consumers before regulatory agencies.

The nation's electric utility consumers, on whose behalf we frequently intervene in rate cases at the federal and state level, have a major stake in the fair implementation of the Staggers Act. Utility coal accounts for almost seven-eights of the coal transported by rail ("Coal Traffic: 1986" (Washington, D.C.: National Coal Association, 1986), p. II-2). Coal is the single most important commodity moved by rail, as measured by carloads, tons and revenues. "Analysis of Class I Railroads": 1985 (Washington, D.C.: American Association of Railroads, August 1986, pp. 115, 121, 127.). The costs of transporting coal are passed through directly to consumers in the form of fuel adjustment clauses or as expenses. Thus, coal rail ratemaking is not a utility profit matter, it is directly and entirely a consumer cost issue.

Because consumer advocates are so intimately involved in the regulatory process and because the consumers we represent are directly affected by the Staggers Act through its impact on the cost of a regulated service, I will focus on the perversion and distortion by the Interstate Commerce Commission (ICC) of sound regulatory practices. I will discuss procedural and substantive flaws in the ICC's handling of the two most fundamental of regulatory tasks—the revenue requirement (the revenue adequacy test in ICC parlance) and setting rates (establishing maximum reasonable rates.).

DISCUSSION

The ICC has routinely found every railroad to be revenue inadequate since the passage of the Staggers Act. For some railroads in some years, that conclusion is in fundamental conflict with the judgment of a variety of financial markets and analysts. Part of the ICC's inability to reach a sensible conclusion in revenue adequacy determination stems from the process it uses.

The process for receiving input from the public and interested parties in determining revenue adequacy must be formalized and opened up. The ICC has recently invited comments for the next determination. But that is just for this year and at the whim of the Commission. What will happen next year, if Congress is not breathing down the neck of the Commission? Will it decide that it does not wish to hear comments. Predictability and openness of process are two key elements in creating fairness in regulation. At present, the revenue adequacy determination lacks both of these.

In determining the revenue requirement, the ICC does not consider multiple indictors on financial performance. Although there is no deterministic formula for using various financial indicators, a broad range of indicators enters virtually every rate proceeding. These indicators are used either to determine the set of companies selected for comparison purposes, or to establish a level of financial performance that is consistent with a reasonable level of return on equity at a specified level of risk. Establishing the revenue requirement without a point of reference grounded in the actual financial performance of real firms is exactly what has led the ICC so far astray.

In determining the cost of capital component of the revenue requirement, the ICC utilizes an industry average, rather than a firm specific cost of capital. There is no such thing as a true cost of capital for an entire industry, because an industry does not raise capital—only individual firms do. By using an industry average, the ICC overtates the cost of capital for the stronger railroads.

The ICC has never scrutinized the rate base to ascertain which items are used and useful in the provision of rail services. In fact, when corporations or markets made judgments about the rate base—establishing their value through sale or write down—the ICC simply ignores these judgments.

The goal of regulatory reform in the Staggers Act was to create an environment in which railroads could cover their cost of service, earn a reasonable profit and achieve financial soundness so that they are able to raise capital in the nations' money market. Under the Supreme Court's rulings inthe *Bluefield* (*Bluefield Water Works* v. *P.S.C.*, 262 U.S. 679 (1923) and *Hope* (*F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944)) cases, state public utility commissions must provide the entities they regulate with exactly the same opportunity—nothing more, nothing less.

The ICC seems to have totally misunderstood this fundamental principle of ratemaking. The Chairman of the ICC has testified that, unlike public utility commissions, who guarantee returns for utilities, the ICC merely provides the opportunity to achieve adequacy. Public utility commissions provide no such guarantees. They provide only opportunities to earn a fair rate of return that is commensurate with the risk faced by the utility.

In part reflecting this flawed understanding of what goes on at other regulatory bodies, the ICC has violated a number of well-established principles of regulation. In the name of revenue inadequacy the ICC has engaged in retroactive ratemaking, denied consumers relief from imprudent actions and allowed shippers to set rates whose fairness and reasonableness has not been scrutinized.

Not only has the ICC misconstrued the function of the regulator, it has misdefined the revenue needs of the railroads in other ways. For example, although debt costs are known and are thus, legal obligations of corporations, the ICC ignores these actual costs and uses a hypothetical cost to calculate the current cost of capital.

Moreover, after years of delay and footdragging, the ICC issued its coal rate guidelines which rely on a stand-alone-cost test as the center piece for establishing maximum reasonable rates. However, the ICC almost immediately admitted that only under a very restrictive set of circumstances would a shipper even contemplate the gargantuan task of putting on a stand-alone-cost case. It declared that small shippers or receivers of goods who rely on multiple movements would find the standalone cost test onerous and unworkable. In its first and obviously precedent setting case for these shippers, it used a different regulatory standard—a formula approach.

To have different rate reasonableness standards for different classes of customers is completely arbitrary and unfair by most regulatory standards, Since these two standards may yield radically different results, they sorely test the prohibition in the Staggers Act that no single commodity bear a disproportionate share of the burden of rail rates.

The formula approach, which was made available to a selected class of shippers, starts with an estimation of the variable costs of service. It then proceeds to review the markup over variable cost for the contested movement in comparison to the markup on other movements which are similarly situated. Under the stand-alone maximum rate standard, however, the ICC still does not require presentation of evidence on the actual cost of service. This is virtually unheard of in other regulatory proceedings. The actual cost of service must be considered if fairness in ratemaking is to be achieved. To be sure, in setting rates for entities that provide a mix of competitive, partially competitive and fully monopolized services costs are not the sole determinant of prices, but they must at least be considered.

The obliviousness of the ICC to the actual costs of services is also reflected in its refusal to incorporate productivity changes into the Rail Cost Adjustment Factor (RCAF). The RCAF is important not only because it sets the limits on automatic rate increases that the railroads may take, but also because it is incorporated in many contracts. The RCAF was supposed to be an index of the costs of providing service—like a fuel adjustment clause—which would enable the railroads to recover those costs without regulatory lag. The ICC's version of the RCAF ignores important economics on the use of inputs that have been achieved in providing service. By ignoring productivity gains, the RCAF has risen much more than the actual cost of service and the ICC has turned an automatic cost recovery mechanism into an automatic windfall.

Finally, for both the stand-alone and formula approaches to establishing maximum rate reasonableness, the burden of proof lies on the shipper, not the railroad. This is virtually unheard of in either state or federal regulation. The regulatory process almost invariably imposes the burden of proof on the party requesting the rate increase because it possesses the most detailed information on the nature and cost of service, not to mention the fact that the entity collecting the rates has a strong interest in setting them too high.

CONCLUSION

I have outlined several procedural and substantive failures in the regulatory process at the ICC. Unfortunately, the ICC has shown no inclination to correct these mistakes. Therefore, only Congress can deal effectively with the problem by passing S. 676 (H.R. 1393)—the Consumer Rail Equity Act.

Establishing procedural fairness will not alter the key elements of regulatory reform embodied in the Staggers Act. The ability to contract, the ability to collect rates while their reasonableness is being determined, and the jurisdictional threshold remain unchanged. The policies and goals of the Staggers Act are reaffirmed in the Consumer Rail Equity Act; thus shifting the burden of proof for justification of increased rates back to the railroad does not alter any of the presumptions in the Staggers Act. Moreover, the shipper must prove it is captive under Section 4 of the proposal.

Procedural balance and substantive reasonableness are crucial to the fairness of the regulatory process. We believe that the changes contained in the Consumer Rail Equity Act will save consumers money, but even if they would not save consumers one penny, we would urge Congress to pass this legisllation to restore equity, balance, and fairness to the regulation of the railroads, exercise monopoly power.

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS

COAL SHIPMENTS

Question 1. The railroads have testified that coal rates have declined since the passage of the Staggers Act and that most coal shipments now move under contract. How have these factors affected the prices utilities pay to transport coal?

Answer. Since coal rates are passed through in electric rates, lower rates absent other increases would, of course, result in lower total fuel costs in rates. In fuel hearings before the South Carolina Public Service Commission my office inquires as to the volumes of coal purchased under contract versus on the spot market. We also inquire as to whether the utility has considered renegotiating contracts to maximize benefits to its consumers.

Our experience suggests utilities favor contract as opposed to spot purchases because of a perceived greater assurance in delivery. Utilities still remember delivery problems of several years ago due to miner and union unrest and are willing, with the approval of regulators to pay higher coal rates than exist on the spot market. Utilities also contend that contract coal is more likely to be of a consistently higher quality than spot coal.

One possible solution to provide an incentive for greater spot purchases to lower coal costs would be renegotiated contracts that are short-term rather than long-term and are for less total volume. Coupled with this compromise position should be greater control and inspection of coal available on the spot market to ensure consistently high quality.

I offer these comments as background information, since transportation costs are an element of the total cost of coal passed to the ratepayer. If a utilitiy is able to negotiate coal purchases as it deems appropriate without meaningful regulatory oversight, then it might unilaterally adopt a position that it should maximize its purchases of contract coal without evaluating contract renegotiating and greater spot purchases on a regular basis. This complacency may indirectly operate to the detriment of electric ratepayers if railroads take avantage of the passthrough of transporation rates by not lowering them for utilities, even if a lower rate would be justifiable. On the other hand, utilities which viogrously fight coal transporation rate increases would passthrough these lower rates to their customers.

I would add that I am not an expert on railroad statistics, so I cannot address the detailed claims made by the AAR, but I am troubled by the use of averages. Some rates are certainly down, but others are up. The Committee was presented evidence of specific instances in which rates were up and excessively so. Moreover, many costs which had been borne by railroads in the past—such as ownership of cars and the cost of high speed unloading facilities—have been shifted to ratepayers.

PROFITABILITY

Question 2. In the Association of American Railroad's written testimony, electric utilities were considered on average, twice as profitable as railroads. What are your views on this?

Answer. First, the reliance on averages is completely misleading. Some railroads are earning more than some electric utilities and visa versa. Moreover, it is not—clear how relevant the comparison is since the two industries and specific members of the industries—face dramatically different economic circumstances. A relevant set of comparison companies should be carefully chosen to evaluate the financial performance of a specific firm in a specific industry.

Second, the comparison made between electric utilities and railroad profitability is not based on consistent data. On the one hand, holding company based comparisons—utilizing standard accounting procedures for entities actually traded on the nations utilities. The rail holding companies that are actually traded are generally much more diversified than the electric utility entities reported. One is comparing the truck, oil, natural gas, real estate and railroad holding companies to electric utilities which are much more likely to be single line entitities.

Third, comparisons between the railroads themselves and electric utilities are hopelessly obscured by the accounting fictions that the ICC has applied to the industry—such as the write up and the failure to scrutinize the asset base.

Thus, the relevant analysis is to review individual railroads and ascertain their firm specific "cost of capital" and their actual earnings based on a reasonable set of accounting assumptions. Neither the AAR nor the ICC does so in their comparisons.

RATEMAKING

Question 3. In your testimony, you both compare the utility rate making process to that used by the Interstate Commerce Commission (ICC) to determine the railroads revenue requirement or adequacy test. You contend that there are procedural and substantive flaws in the ICC process. Given the claims that 75 to 90% of the railroad's business is competitive, what differences do you think should exist, if any, between regulating utilities and the railroad industry?

Answer. With respect to establishing the revenue requirement, the procedure should be the same, since the objective is the same—to provide an opportunity to earn a return on investment equal to that earned by investments of comparable risk—and the capital markets in which the two industries function are similar.

With respect to ratemaking, there are differences between utility ratemaking and ICC process—differences which would persist if the Consumer Rail Equity Act became law. Current law embodies four fundamental concessions to the railroads in light of their unique mixture of competitive and monopoly services.

First, rates go into effect prior to being found reasonable.

Second, the jurisdictional threshold presumes a high degree of differential pricing. Captive traffic cannnot even ask for regulatory oversight until it is making a very sizable contribution.

Second, the jurisdictional threshold presumes a high degree of differential pricing. Captive traffic cannot even ask for regulatory oversight until it is making a very sizable contribution.

Third, the Rail Cost Adjustment Factor allows for rate increases to reflect cost increases without regulatory scrutiny.

Fourth, the railroads are given an additional zone of rate flexibility above the RCAF.

ACCOUNTING

Question 4. In its analysis of the Consumer Rail Equity Act, the ICC has stated that section 7 requires a "mixing (of) asset levels derived from betterment accounting with earnings predicated on depreciation accounting (which) is not consistent with the sponsor's stated desire for traditional public utility practice, but is contrary to such practice. Please respond to this, if possible.

Answer. The switch from betterment to depreciation accounting required a decision about the treatment of items which would normally have been capitalized, but were expenses under betterment accounting. The principle we want applied is that once an item has been expensed, it should not later by recapitalized and depreciated. This principle is consistent with traditional public utility ratemaking which forbids the double recovery of expenses.

Question 5. In further analyzing Section 7 of the Consumer Rail Equity Act, the ICC notes that "the bill will force a departure from the Commission's existing practice of using discounted case flow as the appraisal mechanism, despite the fact that discounted cash flow is the methodology preferred by the majority of state public utility commissions, and despite the fact that the ICC's estimated cost of equity is the same as generally found by utility commissions." Please respond to this, if possible.

Answer. The bill does not force the Commission to abandon or adopt any specific method. In fact, most utility commissions hear evidence from a variety of methods of determining the cost of capital

What the bill does is to require the Commission to examine a range of indicators of financial performance. In fact, in the course of reviewing a variety of estimates of the cost of capital, most utility commissions hear a great deal of evidence dealing with multiple financial indicators. These indicators are used to ensure that the assumptions utilized in calculating the return on equity are reasonable related to reality.

QUESTIONS OF SENATOR DANFORTH AND THE ANSWERS

Question 1. Section 11 of the CURE bill changes the standard for state regulation of intrastate rates. Under Staggers, the states must regulate "exclusively in accordance" with federal law. Under CURE, the states must regulate "consistently" with federal law.

The railroads are concerned that this change, and other procedural modifications in Section 11, would mark a return to the days when regulatory lag resulted in the loss of hundreds of millions of dollars of revenue. What is the purpose for the proposed CURE modification?

Answer. The purpose of the proposed CURE modification is to clarify that states have the discretion to provide the aims of intrastate regulation without compromising interstate regulation.

Neither the purpose nor the effect of passage of this modification would be to cause regulatory lag and loss of revenue to the railroads. Its passage may be viewed as providing some discretion in areas where facilities may be devoted solely to intrastate functions as in telecommunications depreciation ratemaking.

Question 2. Do you believe uniformity in railroad rate regulation is important to the efficiency of our rail system? Do you think that dropping the requirement, that a state certify its rate regulation follows federal law, will hinder uniform rate regulation?

Answer. Uniformity in railroad rate regulation is not per se important or essential to the efficiency of our rail system. Uniform regulation would not be a cure all for a system with the severe competitive pressures facing the railroads. Consistent, lawful regulation is, however, important to enhance achievement of railway efficiency.

Individual states may have particular problems that state regulators would be better able to address than interstate regulators.

Dropping the requirement that a state must certify that its rate regulation follows federal law should not in itself hinder uniform rate regulation should that course be followed; however, the certification requirement should be retained as a reminder and incentive for the states.

Question 3. Have you even lowered a utility's rates knowing that, even with the higher rates, they would not earn the cost of capital? If so, in what percentage of your rate cases has this happened?

Answer. My office provides legal representation of the consumer interest in utility cases and is not the decisionmaker. In one 1984 case involving Carolina Power and

Light Company (Docket No. 84-122-E) the office recommended that the Company be penalized for nuclear power plant mismanagement through a slight reduction in the new authorized rate of return on common equity. This recommendation assumed that the Company was not entitled to as high an increase because of this poor performance. However, since the recommended return on equity with the penalty was still within the Consumer Advocate's recommended range of return on equity, the proposal did not have the effect of not allowing the Company to earn its cost of capital as measured by that range.

Senator EXON. Gentlemen, I want to thank you both very much. You seem to be echoing a feeling that I get from listening to the testimony of several witnesses in support of the CURE legislation, that your main concern is that the ICC has not been giving due consideration, as all of us anticipated that they would when the Staggers Act was passed.

And to carry that one step further, had the ICC given the interpretation of the Staggers Act with regard to captive shippers as provided for in the Staggers Act, we would not need this corrective legislation that you are here today supporting.

Is that an accurate reflection of both of your views?

Mr. HAMM. Somewhat accurate. I think that the Staggers Act of 1980 has already been referred to in earlier testimony, provided extremely broad discretion to the ICC. If Congress intends for an administrative agency to take certain actions, it must provide the guidelines upon which that action might be taken.

And in fact, Congress concluded that broad discretion was appropriate.

Yes, the ICC could have taken certain different steps, and it might have precluded at least some of the uproar that has caused the necessity for these kinds of hearings.

But fundamentally, it seems to me, Senator, that you all need to sit and give some careful examination to what happens if we have a change in the body of the ICC as we move through various political administrations.

It seems to me the role of Congress ought to be to provide some stability on these issues, regardless of who is in office and who is not.

And it seems to me the legislation that was passed is so affected by changes in personalities rather than some of the factual issues determined by Congress that you are asking for future problems unless you narrow down some of these issues so that you know what some of the responses will be.

That will be in fairness not only to the shippers, but in fairness to the railroad industry so they know what that environment will be for long term investment returns and other kinds of decisions they have got to make.

Senator EXON. Mr. Brown.

Mr. BROWN. As a State regulator, Mr. Chairman, I have never ever suggested to any legislator in our State that they have given us too broad a discretion.

Senator EXON. Yes, I was going to ask you that question.

Mr. BROWN. On the other hand, I think that our job is to implement—any regulator's job—is to implement the intent of the legislative body in the State or on the national level.

And I think that had the ICC followed a different course, I do not doubt that the dynamics and concerns on this issue would be significantly less.

I do have some concerns with the Staggers Act, but they are relatively minor. And the one really focuses on the burden of proof issue, which I think could be changed.

On the other hand, had the ICC implemented the statute more effectively, I doubt that I would be here today complaining about it.

Senator EXON. My last question that I would like to ask both you to focus in on this issue again to help give us guidance from your expertise, as regulators at the local level, and therefore, I hope that we relied on your counsel and advice when the Staggers Act was passed, and we want to rely to some extent on your advice as to whether changes are necessary.

First, let me ask, did both of you support or oppose the Staggers Act as it was passed?

Mr. HAMM. With certain reservations, we supported it. We recognized that there needed to be some changes in the marketplace. We needed to recognize changing economic conditions.

And any piece of legislation obviously is a reflection of various compromises. But I think that we supported it, and quite candidly, we expected more in terms of leadership from the ICC than we have gotten.

And I think that unfortunately that is a problem.

Senator EXON. Mr. Brown, anything to add to that, or do you agree?

Mr. BROWN. No, I would totally agree with that.

Senator EXON. Thank you both very much. Senator Rockefeller?

Senator ROCKEFELLER. Mr. Brown, would your Public Utilities Commission use the revenue adequacy test which has been carried out by the ICC, as is now being used by the ICC, and, if not, why not?

Mr. BROWN. Well, actually we have the President of American Electric Power sitting behind me, whom I think would salivate over the opportunity to have the Ohio Commission apply those tests to American Electric Power's rates in Ohio.

We would not apply those kinds of tests in Ohio, and the reason we would not apply them is because, first off, we have statutory guidelines that set out exactly what kinds of tests that we are supposed to apply, and what we are pegging to is the cost of service. I do not think the ICC in any way does that.

Let me go into for just a second the way they calculate the rate or take a look at what the investment of the railroad is. In fact, there is no scrutiny whatsoever of the railroad's investment. There is absolutely no look at what the imbedded cost of capital is to the railroad. Rather, they use the current cost of capital. No State regulatory body that I know of and certainly not Ohio applies that; nor is there any effort to make sure that when accounting changes occur that we have not avoided double recovery. I think that the ICC scrutiny simply does not exist, and I do not know of any State commission that apply similar level or similar lack of scrutiny.

Senator ROCKEFELLER. You would be somewhat reluctant to allow a $7 billion double writeoff?

Mr. **Brown**. I would suspect that we would be somewhat reluctant, that is correct.

Senator **Rockefeller**. Mr. Hamm, if the South Carolina State Public Service Commission proposed to judge railroad or a utility's financial adequacy based upon ICC revenue adequacy tests, what would you do about it?

Mr. **Hamm**. Well, I think as in Ohio, I would immediately challenge it in court simply because they would not have the authority to do that. Fortunately, the general assembly not only in South Carolina but, indeed, in all 50 states has considered these kinds of issues, and not any state has concluded that that kind of regulation provides meaningful review not only for the customers, the utility customers, but for the companies involved.

It seems to me that you hear a thread of testimony throughout here as well, we want to sort of avoid looking a any specific financial data on particular companies, which is incredible. Obviously, averages reflect just that, an average.

You do not have an average constituent. You have individual people ultimately when it comes down to it, and you have to be very careful with averages. Unfortunately, the ICC has been very comfortable with the application of averages, and some companies do extremely well and some do not.

It seems to me that the regulatory process even in the deregulated environment wants to encourage effective and efficient operations, and you do not do that by the use of averages.

Senator **Rockefeller**. Let me ask a follow-up question.

If the South Carolina Public Service Commission proposed to set utility rates by using the ICC stand-alone cost test, what impact would that have?

Mr. **Hamm**. Given the variance in numbers, again, I have been involved in hundreds of rate proceedings in South Carolina, and the numbers would be staggering.

I guess the question ultimately comes down to what relevance would they be. I am concerned, for example, that the ICC does not take a specific look at the actual cost of service. I do not think that necessarily cost of service ultimately must be the final driving point for the establishment of rates, but how can you hear assertions about revenue inadequacy and those kinds of issues when you have not done a careful analysis to know what it is costing to provide that service.

It is interesting to me that there is such a fear of providing that kind of data. It seems to me that the regulatory process is designed to allow all the parties, not only those subject to regulation in terms of the railroads themselves but anyone else, the opportunity to present evidence and say, look, here is the real world, here are the economic consequences that we are dealing with, here are the results of our economic indicators, and we believe when you review that the only conclusion can be such and such.

It seems to me that the CURE bill is attempting to encourage the presentation of factual data. In fact, if the data would support some of these rate changes or rate increases or whatever, we are going to have to live with those things.

It seems to me to be a deviation of sound public policy that we stand back and say, look, we are simply not going to look at company-specific data. I think that that is where you have an opportunity to at least force the ICC to consider those kinds of issues.

Senator ROCKEFELLER. Mr. Brown, I assume you would not disagree with that?

Mr. BROWN. No, I would not disagree with that. In specific response to your question, it is my belief that if we would apply the ICC's formula in Ohio we would probably see a six- or seven-fold increase in electric rates.

Senator ROCKEFELLER. Would you say that again, please?

Mr. BROWN. I believe we would see about a six- or seven-fold increase in electric rates.

Senator ROCKEFELLER. Let me ask both of you. Do utility customers, therefore ratepayers, in fact pay the cost of railroad co-hauling rates?

Mr. BROWN. That is exactly what it is, Senator. In fact, the cost of shipping coal is part of the fuel clause in Ohio, and that is a dollar-for-dollar recovery that the utilities, whatever they pay they recover from the ratepayers. So we are talking about the ratepayers of electric utilities paying for the cost of shipping captive coal.

Senator ROCKEFELLER. This is not, then, a profit item for the utilities?

Mr. BROWN. Absolutely not.

Senator ROCKEFELLER. It is right out of the consumers' pockets?

Mr. BROWN. Exactly.

Senator ROCKEFELLER. My final question, Mr. Chairman, to both of you, and you have both answered this but I want this on the record, that the ICC has done, as has been suggested by the Federal Railway Administrator, a good job of implementing the shipper protection provisions of the Staggers Rail Act?

Mr. Hamm?

Mr. HAMM. Well, if a good job contemplates basically ignoring their problems, then I think the answer is yes. If a good job includes a careful examination of the problems, a realistic response and approach, then in fact the answer has obviously got to be no.

Mr. BROWN. Senator Rockefeller, in response to that, in the tradition of Senator Mansfield, no.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Senator EXON. Thank you, Senator Rockefeller.

Senator Adams.

Senator ADAMS. I have no questions, Mr. Chairman.

Senator EXON. Thank you very much.

Gentlemen, thank you very much for your interesting testimony. We appreciate your making a special effort to come here this morning.

We will now call on our last panel and ask that they come forward at this time: Mr. Richard Disbrow, President of American Electric Power Company on behalf of the Consumers United for Rail Equity; Mr. Fred Zitto, President, Procompetitive Rail Steering Committee; Mr. John Lind, Vice President, National Industrial Transportation League; Mr. William Dempsey, President, Association of American Railroads; and Mr. Frank R. Breslin, Director of Transportation, Scott Paper Company, on behalf of the Committee Against Revising Staggers.

Gentlemen, I welcome you to the subcommittee hearing today. Thank you for coming as we continue to collect all the information that we possibly can on this very important matter. We will start out the testimony with Mr. Disbrow.

STATEMENTS OF RICHARD DISBROW, PRESIDENT, AMERICAN ELECTRIC POWER CO., ON BEHALF OF CONSUMERS UNITED FOR RAIL EQUITY, ACCOMPANIED BY ROBERT SZABO, EXECUTIVE DIRECTOR; FRED M. ZITTO, PRESIDENT, PROCOMPETITIVE RAIL STEERING COMMITTEE; JOHN LIND, VICE PRESIDENT, NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE, ACCOMPANIED BY JOHN F. DONELAN, COUNSEL; WILLIAM DEMPSEY, PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS; AND FRANK R. BRESLIN, DIRECTOR OF TRANSPORTATION, SCOTT PAPER CO., ON BEHALF OF THE COMMITTEE AGAINST REVISING STAGGERS

Mr. DISBROW. Thank you, Mr. Chairman. I am Richard Disbrow, President of American Electric Power Company, Inc., whose eight operating utilities serve portions of seven midwest states.

Our system is essentially coal fired. We burn between 40 and 45 million tons of coal annually; therefore, the price of coal and coal transportation is of great importance to us. Together, they represent 35 to 45 percent of our revenue dollar. Our annual rail transportation bill alone stands at $120 million. However, the burden of this does not fall on the company. The cost of fuel, including its transportation, is borne directly by our consumers as part of the fuel adjustment clause.

Our interest in reasonable rail rates is to protect our consumers' interests and to facilitate the economic development of the region we are privileged to serve. Today I am representing Consumers United for Rail Equity, or CURE, a large and widely diverse coalition of shippers. I am accompanied by Mr. Robert Szabo, Executive Director of CURE.

CURE is not recommending, as some have alleged, to gut the Staggers Act. To the contrary, what we are urging is some fine-tuning of the regulation already explicit within the Act. We believe there is a need for explicit instructions within the Act on how the ICC must approach the reasonableness of tariffs for captive shippers and for a reasoned definition of revenue adequacy.

Quite frankly, and I did not confer earlier with Commissioner Brown, if the present revenue adequacy test were to be applied to the electric utility industry, I would find it very doubtful that any electric utility would be found revenue adequate. If, indeed, the rates were increased to the point of revenue adequacy, I would find it equally doubtful that our consumers could afford to pay their bills.

I am not here to urge imposition of electric utility rate regulation on the Nation's railroads. CURE is not contesting the legislative judgment in establishing a jurisdictional threshold of 180 percent of variable costs in tariffs for captive shippers. What CURE is recommending is that when tariffs in excess of that jurisdictional threshold are imposed, the ICC make a reasoned, fair and prompt assessment of any complaint, with action taken as warranted.

Proving the rate is in excess of the jurisdictional threshold and railroad market dominance exists is onerous enough, but to add to this the burden of stand-alone cost analysis essentially assures there is no remedy.

The record of the ICC with regard to captive shipper complaints is prima facie evidence of this fact despite a couple of recent decisions favoring captive shippers.

Another aspect that we would like to address is the rail cost adjustment factor. The rail cost adjustment factor should recognize actual cost and productivity improvements, and the factor should be adjusted upward and downward accordingly.

In conclusion, we support the intent of the Staggers Act and seek through legislative change merely to avoid undue burdens being placed on captive shippers. In turn, the changes we are recommending should not be unduly burdensome to the financial health of the Nation's railroads.

Thank you.

[The statement and questions and answers follow:]

STATEMENT OF RICHARD E. DISBROW ON BEHALF OF CONSUMERS UNITED FOR RAIL EQUITY

Mr. Chairman and members of the Subcommittee, my name is Richard E. Disbrow. I am President of American Electric Power Company, which is headquartered in Columbus, Ohio. Our company serves electricity consumers in the states of Indiana, Kentucky, Michigan, Ohio, Tennessee, Virginia and West Virginia. I appear before you today on behalf of Consumers United for Rail Equity, a group that has been formed to support the enactment of the Consumer Rail Equity Act (S. 676).

American Electric Power Company is one of the major coal purchasers of the nation. In 1986, our company received a total of approximately 42,500,000 tons of coal for use in our various coal-fired electric generating facilities. Approximately 23,200,000 tons of this coal was moved by rail or a combination rail-barge movement, with the remaining tonnage moving by truck, conveyor belt or exclusively by barge. Our coal moved on major railroads operated by the Norfolk Southern Corporation, Conrail, CSX Transportation, Burlington Northern and various short line railroads. Our total railroad coal haulage bill in 1986 was in excess of $119 million.

We are involved in this legislative effort because every dollar of our $119 million in annual railroad coal haulage costs is passed along directly to our electric ratepayers, including our residential, commercial and industrial customers. We are not allowed to make a profit on our cost of hauling that fuel, nor are we allowed to keep any portion of any railroad rate reductions that we are able to obtain. Our corporate interest in this matter is in the protection of our customers from unreasonable transportation charges and in assuring that our electricity rates do not include unnecessary charges that can disadvantage the region we serve.

Mr. Chairman, I understand that the testimony of the Interstate Commerce Commission at the last hearing suggested that the captive shipper problem was basically a problem concerning the backlog of cases that have been pending at the Comission for up to ten years. Certainly these ongoing cases are a major problem that must be resolved, for all the reasons that were discussed at that hearing. But I want you and the members of this Subcommittee to know, Mr. Chairman, that the captive shipper problem is an ongoing problem of the present and the future as well.

As our major coal use would suggest, American Electric Power Company is constantly in the coal buying market. While we have long term coal contracts, a portion of our purchases are for rather short periods of time. In fact, in the volatile coal market today, our coal contracts are in the shorter range because coal producers are not interested in committing to sell coal for long periods of time at today's depressed coal prices.

Just as we are constantly in the coal buying market, we are also constantly in the coal transportation market trying to obtain cost effective transportation for the coal we have purchased. We work hard at avoiding captivity and are successful in the majority of cases. In those cases, we find, as you would expect, that competition affords us the negotiating power to obtain very competitive and reasonable transportation prices, whether by truck, rail or barge. However, in a minority of instances, with several of our plants, we have found ourselves to be without competitive transportation alternatives. In those instances, unless we can find a way to create competitive alternatives, our only negotiating leverage comes from the active enforcement by the Interstate Commerce Commission of the shipper protections of the Staggers Act. The importance of this leverage is highlighted by the testimony of several railroad executives that there are no captive shippers on their railroad systems.

Mr. Chairman, we, like many captive shippers, have been very disappointed in the ICC's implementation of the captive shipper protections of the Staggers Act. We, too, have noticed that the Commission only seems to act to protect shippers when Congress applies significant pressure on the Commission. However, the effectiveness of the captive shipper rate reasonableness process at the ICC—not the marketplace—defines the environment in which we must negotiate rail rates when we are captive: does the captive shipper with a genuine grievance have a reasonable chance of victory, such that the railroad will negotiate with the captive shipper? So even when Congress is not actively focusing on this issue, it is important that the Commission be seen to be vigorously enforcing the captive shipper protections of the Act.

Mr. Chairman, the rate reasonableness process at the ICC is long, complex and expensive. Unless the captive shipper is willing to accept a contract rate that is dictated by the railroad, the railroad establishes its rate on the captive shipper by filing a tariff. No prior Commission approval is required for the tariff to take effect. Then, the captive shipper must hire a consultant or have the in-house capability to determine if the rate in question generates a revenue to variable cost ratio of at least 180 percent. If so, the captive shipper may file a complaint at the ICC. The ICC will have jurisdiction to determine the reasonableness of the rate if the captive shipper proves that (1) his rate generates a revenue to variable cost ratio of at least 180% and (2) the shipper is subject to "market dominance". In the market dominance determination, the shipper must show that he has no intramodal transportation alternative (another railroad) and no intermodal transportation alternative (such as truck or barge), but the railroad my rebut this showing by proving that the shipper has an effective product alternative (such as another form of fuel for use in an electric generating plant, or even the ability to purchase electric power from the grid) or an effective geographic alternative (such as coal from another area of the country or even coal imports from abroad).

Once the captive shipper has proven that the ICC has jurisdiction to determine the reasonableness of his rate, the captive shipper then also has the burden of proving that his rate is unreasonable. The Commission did not even have a rate reasonableness test until September 1985, nearly five years after passage of the Staggers Act, when it adopted the Coal Rate Guidelines. More recently, as we duscuss below, the Commission has admitted that there are problems with the Coal Rate Guidelines and is moving toward abandoning the guidelines for all but a handful of cases.

The Coal Rate Guidelines provide three alternative avenues of relief from an unreasonably high railroad coal rate. First, the Commission can grant some type of unspecified rate relief if the railroad in question is shown to be revenue adequate by either the Commission or the captive shipper. Second, the shipper can obtain rate relief from a revenue inadequate railroad if the shipper can prove that the railroad is mismanaged and the entire revenue shortfall of the railroad is attributable to that mismanagement. Finally, the shipper can obtain rate relief if he can prove that his rate exceeds "stand-alone cost"—the cost of a group of shippers providing their own hypothetical competing transportation system. While these matters are being deliberated at the ICC, the captive shipper pays the rate in question.

None of these rate reasonableness test options for coal shippers is very attractive, although two recent captive shipper rate victories were achieved under the "stand-alone cost" option. From the enactment of the Staggers Act until August 7, 1986, no captive shipper had obtained rate relief at the ICC.[1] On that date, as the House Committee on Energy and Commerce prepared to consider a compromise of the Consumer Rail Equity Act as part of the Conrail Privatization Act, the Commission found for the captive shipper in *Omaha Public Power District* v. *Burlington Northern.*[2] Interestingly, the next captive shipper victory came on May 13th, the day before the chairman of the ICC was scheduled to appear at oversight hearings in the House Committee on Energy and Commerce, in the matter of *Arkansas Power and Light Company* v. *Burlington Northern.*[3] Then, on May 27th, the day before the ICC

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[1] The City of San Antonio had received an award of reparations earlier in 1986, but that was under a special section of the Staggers Act unavailable to any other shipper.

[2] Docket No. 38783, written decision served November 20, 1986.

[3] Docket No. 36719, written decision served May 13, 1987.

Chairman testified before the House Committee, the Commission began to retreat from the Coal Rate Guidelines, entering a "tentative" decision in *McCarty Farms* v. *Burlington Northern* [4], a grain captive shipper case.

Mr. Chairman, I find at least one aspect of the Commission's *McCarty Farms* decision and one reported portion of the Commission's testimony at both the May 28th hearing in the House and the June 17th hearing in this Committee to be particularly disturbing. I understand that the Commission testified that *McCarty Farms* is the first application of a new rate reasonableness test that the Commission proposes to adopt for non-coal captive commodities and "small coal." While I am told that the testimony of the Commission at these two hearings did not clearly define "small coal" for purposes of this new rate reasonableness test, I am going to assume, Mr. Chairman, that American Electric Power is not likely to qualify as "small coal". Thus, my company and its customers are likely to continue to be required to prove rate reasonableness under the "stand-alone cost" concept.

What I find to be particularly disturbing for my company and my customers is the reason given by the Commission for not applying "stand-alone cost" in the *McCarty Farms* case:

"The large number of origin points in this case makes the development of CMP [constrained market pricing] evidence, especially stand-alone cost evidence, *an extremely complex and onerous task.* Presentation of a SAC analysis in this proceeding would require the development of evidence on the cost of assembling and operating an efficient transportation network to handle the Montana grain now moving on the BN. The development of such evidence would be *extremely complex and would entail substantial expenditures,* in terms of time and money, relative to the possible savings to be obtained through rate relief. Thus, in view of the *extreme complexity and resulting economic burden on complainant* of developing evidence, we would not apply constrained market pricing to resolve the disputes in this case".[5]

Mr. Chairman, this statement by the Commission seems to describe coal. No single Eastern coal mine can supply more than a fraction of our fuel requirements, and not all mines can supply the best coal for our plants, so we solicit bids from a large number of mines and locations. Thus, our sources of coal consist of a large number of origin points, making the development of stand-alone cost evidence "an extremely complex and onerous task"—just as in the Montana grain markets.

While I am happy for the grain industry that the Commission has "tentatively" determined that the stand-alone cost test should not apply to grain, I fail to understand why it should apply to my company's ratepayers for coal purchases or to anyone, for that matter. It is no more reasonable to force my ratepayers to pay for a proceeding that the Commission itself characterizes as being "extremely complex and onerous" and an "economic burden" than it is for any other captive shipper. It is no wonder that the ICC captive shipper process provides little hope for shipper relief and, thus, provides captive shippers with very little negotiating leverage—especially with companies that refuse to even acknowledge the existence of captive shippers in testimony before the Congress.

Thus, seven years after the enactment of the Staggers Act, the rate reasonableness issues remain confused and unsettled. The ICC has discredited its stand-alone cost test by the statements in its *McCarty Farms* decision. The "tentative" decision in *McCarty Farms,* the ICC has now testified, may not be the "final" decision. The railroad industry also now has testified in opposition to the test applied in that "tentative" decision. The Commission's testimony in both the House and Senate has demonstrated no awareness of how it might distinguish "small coal" from coal that would be forced to continue to rely on the stand-alone cost test for potential rate relief. It is worth pointing out, too, that in many other major proceedings, the ICC's final decision has been far different from its initial proposal, and that these proceedings have often gone through several stages over many years.

Mr. Chairman, our request is that the Committee act legislatively to assure that the captive shipper rate reasonableness process is sensible, predictable, balanced and fair. Under the Consumer Rail Equity Act, the railroads would continue to set rates without prior Commission approval, the captive shipper would continue to bear the burden of proving that the Commission has jurisdiction to determine the reasonableness of his rate, and the captive shipper would continue to pay the disputed rate during the pendency of the ICC proceeding, unless the Commission determines otherwise under existing Staggers Act provisions.

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[4] Docket No. 37809, written decision served May 27, 1987.

[5] Docket No. 37809, decision served May 27, 1987, pages 15-16 (emphasis added).

The Consumer Rail Equity Act would replace the present "revenue adequacy" test with the type of test applied by the state public service commissions; the "market dominance" determination would no longer consider product or geographic competition—it is hard to conceive of a captive shipper who would enter the ICC process if he had true negotiating leverage as a result of true product or geographic alternatives; and once the shipper has demonstrated market dominance, the burden of proving rate reasonableness would shift from the captive shipper to the railroad. When determining the reasonableness of a rate, the Commission could allow shippers to use all of its present tests, but would also be required to consider the difference between the rate the railroad is charging and the actual cost of service. Finally, during a rate reasonableness case the Commission would be required to make affirmative findings on the Long-Cannon factors. These factors were included in the Staggers Act to prevent railroads from charging captive shipper rates that reflect railroad pricing or operating inefficiencies, but Commission decisions have effectively written these captive shipper protections out of the law.

Let me address specifically each section of the Consumer Rail Equity Act (S. 676) briefly:

Section 2.—Purpose.—This section reaffirms the goals of the Railroad Revitalization and Regulatory Reform Act of 1976 (the 4R Act) and the Staggers Rail Act of 1980, and declares the intent of Congress that this bill shall assure that the previous two Acts are administered in a balanced manner that both provides adequate protection for those subject to railroad market dominant pricing power and maximizes the opportunities for intramodal competition.

Section 3.—Market Dominance.—Under the Staggers Act, the ICC has jurisdiction to determine the reasonableness of only those rates that are charged to "captive shippers". The Act defines a "captive shipper" as a shipper that (1) is paying a rate that exceeds the jurisdictional threshold established in the Act (180% revenue to variable cost ratio) and (2) is subject to railroad "market dominance". The Consumer Rail Equity Act does not change these fundamental concepts.

On July 31, 1985, the Commission adopted a new "market dominance" test under which the shipper must prove that it has no transportation alternatives, but the railroad could allege and prove that the shipper has a "product" or "geographic" alternative. "Product" alternatives might be the use of fuel oil instead of coal in the case of a utility or one type of grain instead of a second type of grain in the case of a bakery or feed lot. "Geographic" alternatives might be Pennsylvania coal instead of West Virginia coal or eastern coal instead of western coal in the case of a utility, or midwestern grain instead of North Dakota grain in the case of a bakery or export broker.

While shifting the burden of proving the existence of "product" and "geographic" competition was an improvement in the Commission's market dominance test, it nonetheless left those two obstacles to Commission jurisdiction in place, together with all of the opportunity for delay and discovery abuse they have often presented in the past. If a shipper can prove that it lacks transportation alternatives and is paying a rate of at least 180% of the railroad's variable costs, the possibility that other forms of competition might effectively discipline a rate that high is too speculative. Market dominance decisions at the Commission have not often turned on the product or geographic competition issues, so those issues have in practice become delaying tactics. The *McCarty Farms* case consumed six years before the Commission decided the market dominance issues, primarily product and geographic competition. In recent months, a Federal Court has overturned one "geographic" competition finding by the ICC, and the ICC has reversed itself on two other "geographic" competition findings.[6]

Therefore, the bill eliminates consideration of product and geographic competition in market dominance decisions. The shipper will continue to have the burden of proving that it lacks transportation alternatives and is paying a rate in excess of the cost recovery percentage (currently 180% of variable cost).

Section 4.—Rate Reasonableness.—A persistent complaint about the present administration and interpretation of the law has been the Interstate Commerce Commission's standard for determining the reasonableness of a rate that is being charged a captive shipper. In its Coal Rate Guidelines, the Commission has embraced a philosophy of maximum rate reasonableness based almost entirely on demand for rail freight service, rendering the actual cost to the railroad of providing the transportation nearly irrelevant as a ratemaking consideration. In almost all other instances in which a company possesses monopoly power—and Congress recognized in the Staggers Act that railroads continue to possess monopoly power with regard to captive shippers—some consideration of cost is included in the disciplining of abuses of that monopoly power.

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[6] *General Chemical Corporation* v. *ICC*, No. 85-1347 (D.C. Circuit, slip opinion May 1, 1987) (soda ash); *General Electric* v. *B&O Railroad*, Docket No. 381255, decision served March 17, 1987 (methyl chloride); *General Electric* v. *Conrail*, Docket No. 37477, decision served May 4, 1987 (heavy electrical equipment).

The Consumer Rail Equity Act will not impose utility-type rate of return-based regulation upon market dominant carriers. The conclusive presumption that no market dominance can be found for a rate yielding revenues below 180 percent of variable cost, which precludes the Commission from even entertaining a complaint about a rate below that level, represents a fundamental policy judgment of the Staggers Rail Act that some shippers and receivers will be required to pay a greater share of the revenues needed to develop and sustain a sound national rail transportation system.

This bill does not revisit that policy decision of the Congress. This legislation does not quarrel with the jurisdictional threshold of the Staggers Act or with the judgment that some shippers and producers, and by extension some consumers, should pay more than others for rail transportation. Section 4 of the bill does, however, alter the method by which the Commission has been reviewing the reasonableness of rates of carriers possessing monopoly power. The Consumer Rail Equity Act requires the Commission to give careful attention to the railroads' costs and revenue needs.

On September 3, 1985, the ICC adopted the Coal Rate Guidelines which contain the rate reasonableness standards for captive coal. The final guidelines provide three alternative "constraints" for captive coal rates. Under all three, the captive shipper has the burden of proof.[7]

First, if the railroad is revenue adequate, the coal transportation rate is constrained in some unspecified fashion. However, in light of the ICC's consistent failure to adopt a realistic revenue adequacy test, this constraint has little significance. This is particularly true since the ICC has indicated that this constraint—which is not defined—will apply only after the rail carrier is revenue adequate "over time," which could mean several years.

Second, according to the ICC, proof that a carrier's revenue inadequacy is due entirely to management inefficiency will constrain the rate. In its recent *Arkansas Power & Light Company* decision, the Commission explicitly stated:

"The dollar amount of those inefficiencies must be shown to be high enough so that, if eliminated, the carrier would be revenue adequate." [8]

During the three years in question in that case, the revenue adequacy shortfall of the railroads, according to the ICC's standards, totalled over $2 billion.[9] This imposes an unprecedented burden of proof on the shipper, especially in light of the magnitude of overstatement of revenue need built into the ICC's current revenue adequacy test. It is now virtually certain that shippers will not attempt this approach to rate relief.

Third, the guidelines retain "stand alone cost" as an upper limit on rates. Stand alone cost is the cost to a shipper or group of shippers of building and operating their own railroad at today's prices. In other words, if a shipper thinks the quoted rate is unreasonably high, the ICC requires the shipper to demonstrate the cost to build and operate a substitute transportation facility at current prices. To date, the Commission has issued just two decisions based on "stand alone cost", the *Omaha Public Power District* and *Arkansas Power & Light Company* cases discussed above.

In the *Omaha Public Power District* case, the shipper was awarded about $17 million in reparations plus interest, which is welcome relief. It should be emphasized, though, that the Commission itself said the rate in question in that case was one of the four highest unit train rates charged by the railroad. Moreover, the railroad was charging about $13 a ton, but argued that the "stand alone" cost was $41 per ton, while the shipper argued that the "stand-alone cost" was between $7 and $9 per ton. Captive shippers are obviously concerned about a test that results in such broad disparities.

In the *Arkansas Power & Light Company* case, the shipper was awarded $22 million in reparations plus interest, which is also welcome relief. Two things are worth noting about this decision. First, as discussed above, this decision appears to represent the final death knell of the Long-Cannon amendment's protection against captive shipper subsidization of railroad inefficiencies. Second, the Commission emphasized that the shipper's stand-alone cost evidence would work only for Powder River Basin shipments, which involve huge volumes of coal moving over a densely travelled corridor.[10]

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[7] A fourth "constraint," phasing, is not a rate reasonableness test but is rather a method of phasing in the payment of a "reasonable" rate.

[8] Docket No. 36719, decision served May 13, 1987, at page 9.

[9] Id. at page 8, fn. 2.

The usefulness and validity of stand-alone cost and the consistency of the Commission's entire approach to rate reasonableness have now been called into serious question by the Commission's "tentative" decision in *McCarty Farms*, a case filed in 1981 by a group of Montana grain farmers seeking relief from high rail rates on grain shipments to the Pacific Northwest. The Commission has long conceded that its stand-alone cost test is too expensive for small shippers[11] and had sought comment in May of this year on several alternative tests for commodities other than coal and small coal.[12] In *McCarty Farms*, the Commission "tentatively" found the rates charged to the grain farmers unreasonably high based on one of those proposed alternatives tests, a limit based on the average revenue to variable cost ratio for all captive movements of the commodity in question. As discussed above, the Commission conceded the burden and expense of trying to apply stand-alone cost to almost any situation other than high-volume, high-density shipments from a single or highly concentrated source.

Thus, the Commission appears to be moving toward using one test it describes as "extremely complex and onerous" for a relatively limited group of shippers which includes my customers, and at least one and possibly more alternative tests for other shippers, with little or no principled basis for the distinctions.

The bill provides that the Commission, within one year after the enactment of the Act, must adopt rate reasonableness standards that apply to all captive commodities (except recyclables that are subject to a separate statutory rate test). The new standards must consider, among other factors, the railroad's need for revenues, the relationship of the rate to the railroad's cost of providing the service, (including, where relevant, the fact that the shipper is helping to relieve the railroad's cost burden by supplying cars, paying for loading facilities or the like) and whether and to what extent the railroad's revenue needs require captive shippers to pay rates that exceed the jurisdictional threshold.

The bill also requires that the Commission inquire into and make affirmative findings respecting the Long-Cannon factors. Thus, the Commission can no longer avoid implementing these factors, either by suggesting that the complainant has to show that the railroad would be revenue adequate but for its inefficiencies before a rate reduction will be ordered, or by ignoring the factors altogether.

Section 5.—Amendments to Rail Transportation Policy.—The bill expands one of the fifteen national goals to be achieved in the implementation of the Staggers Rail Act of 1980, to provide that the Commission must consider the competitive positions of domestically produced commodities. At a time when it is becoming increasingly clear that the nation's position in world markets is not what it should be, Congress should tolerate no unjustifiable barriers to the competitiveness of America's commodities. The testimony last week before this Committee of a West Virginia coal producer, William G. Skewes, proves conclusively that high railroad rates are costing this nation real opportunities to compete in world markets.

The bill also clarifies that another of the national goals is to ensure that rail rates to captive shippers must be reasonable even if a railroad is revenue inadequate.

Section 6.—Inflation Based Rate Adjustments.—The Commission calculates each quarter an inflation index called the Rail Cost Adjustment Factor. In response to widespread criticism during the last Congress, the Commission made some welcome changes in how the index is to be applied to tariff rates, but the need for reform remains.

In its decision in *Railroad Cost Recovery Procedures*, Ex Parte No. 290 (Sub-No. 2), served October 17, 1986, the Commission finally corrected the most egregious error it had previously made concerning the index. It decided that as the index declines, tariff rates raised in reliance on the index must also decline. The bill is needed to confirm the Commission's authority to accomplish this change. The Commission has suggested in the past that it might lack the authority to make this change, and that issue is presently in the courts.

More importantly, as their own testimony before this Committee last week made clear, the railroads have made significant strides in productivity since the Staggers Act. The Rail Cost Adjustment Factor that is used by the Commission today does not reflect these cost savings and productivity gains, but reflects only increases in the prices paid by the railroads for goods and services. The Consumer Rail Equity Act requires the index to reflect increases in actual costs, not prices, and productivity gains.

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[10] Decision at page 16.

[11] See, e.q., testimony of Heather J. Gradison, Chairman, Interstate Commerce Commission, before the Senate Committee on Commerce, Science, and Transportation, February 21, 1986, at page 27.

[12] Ex Parte No. 374 (Sub-No. 2), served May 21, 1987.

The bill also requires the Commission to recompute the index for cumulative forecast errors.

Section 7.—Standards and Procedures for Determining Revenue Adequacy.—A critical goal of both the Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980 was the attainment, by our nation's railroads, of "revenue adequacy." Section 10704 of Title 49 thus directs the Interstate Commerce Commission to determine regularly which carriers are receiving adequate revenues, that is, revenues that are sufficient "under honest, economical, and efficient management," to recover operating expenses, including depreciation and the replacement of obsolete assets, together with a "reasonable and economic profit or return (or both) on capital employed in the business." This very well may be the most important element in the Staggers Act because this analysis can determine the burden that is to be carried by captive shippers.

Again in response to widespread criticism, the Commission proposed during the last Congress to change its revenue adequacy test to the type of test used by public service commissions. Ultimately, the Commission's promise to reform its test was not kept. In a decision served on December 31, 1986, the Commission did agree to exclude deferred taxes—which are an interest-free loan from taxpayers—from investment base, but dropped other important aspects of its proposed test.

Accordingly, this section of the bill seeks to assure that revenue adequacy determinations are based upon realistic measurements of a railroad's financial health. This is accomplished by requiring the Commission to use the same kind of analysis used by public service commissions.

In making revenue adequacy determinations and applying them in administering the law, the Commission shall identify revenues, expenses and the investment base that are reasonably related to providing rail service, and place railroads on the same footing as any other industry by valuing assets at original cost reduced by straight line depreciation. Deferred taxes will not be included in the investment base, nor will assets that have been previously expensed against income. In determining the cost of capital, the Commission shall use actual or embedded cost of debt and reasonable estimates of the cost of equity, based on the kinds of measurements applied by public service commissions.

The revenue adequacy determination is to be made annually and shall allow for adequate public comment on the non-proprietary information submitted by the railroads.

The first two Long-Cannon factors are to be applied in making revenue adequacy determinations. If a railroad is pricing a portion of its traffic inefficiently, the revenue shortfall attributable to that practice should not be considered in deciding whether the carrier is otherwise revenue adequate. These broader inquiries do not dictate any particular outcome, but they should assist in producing more complete assessments of revenue adequacy.

Finally, to assist the Commission in its rate reasonableness proceedings, the revenue adequacy determination is to include a specific Commission finding on the extent of revenues required to achieve or maintain revenue adequacy.

Section 8.—Exemptive Authority.—The Commission is directed in 49 USC § 10505 to pursue exemptions from regulation where the regulation is not necessary to carry out the transportation policy set out in section 10101a, and is either (a) of limited scope or (b) no longer needed to protect shippers from abuse of railroad market power. This section would provide that an exemption "may" be issued if the Commission finds there is no market dominance (within the meaning of section 10709, as amended by Section 3 of the bill) over the transportation involved in the exemption. This section also provides that the Commission should consider whether persons other than shippers (including producers and consumers) require protection from abuse of railroad market power sufficiently to deny issuance of an exemption. These changes are intended to prevent the use of the exemption power in circumstances where competitive forces do not exist to effectively discipline railroad monopoly power.

The bill also provides that exempt commodities or transactions shall be subject to all other relevant federal laws. If an exemption is intended to deregulate a commodity or transaction, then the federal laws that govern all other non-regulated, competitive situations shall apply.

Section 9.—Enhancement of Competition.—A sound national rail transportation system involves a significant amount of interdependence among carriers. The majority of rail freight shipments travel over the lines of at least two carriers. Often, the business relationships among carriers are a critical factor in determining whether a shipper will enjoy the benefits of competition between at least two rail carriers.

One important inter-carrier practice involves the treatment of shippers located on one railroad which interconnects with one or more other railroads able to efficiently provide the long haul portion of the transportation. If the railroad that serves the shipper will enter into competitive joint rates with the other railroads, the shipper will have a competitive choice for the long haul movement. If that railroad refuses to quote joint rates or cancels existing joint rates on efficient routes, the effect will be to force the shipper to use exclusively the railroad that controls access to the shipper's facility, at a needlessly greater cost to the shipper and a loss of efficiency for society as a whole. A captive shipper is created, and marketplace forces are thwarted.

In many areas, two (or more) carriers with long haul lines into the area can efficiently serve shippers on each other's lines if they agree to allow one another access to each other's lines in the area, or if one carrier otherwise agrees to act as a switching agent for the other carrier. Thus, the carriers can enter into a terminal facilities agreement, where the carriers are permitted to operate on each other's lines to reach shippers located throughout the terminal area, or a reciprocal switching agreement, allowing mutual access to each other's shippers.

The widest possible use of these various inter-railroad practices is essential to providing shippers and receivers with competitive alternatives and is essential to the maintenance of efficiency. Current law contains several provisions to assure that rail carriers do not cancel or refuse to enter into these arrangments for anticompetitive reasons. The Commission's record of enforcing these provisions is poor, probably because it has disavowed any affirmative obligation to use these provisions to promote rail to rail competition. This interpretation directly contradicts the language and legislative history of the Staggers Rail Act of 1980. This section of the Consumer Rail Equity Act would strengthen these procompetition provisions.

The bill would amend 49 USC 10705 to provide that, on request of a connecting railroad or a shipper or receiver, a railroad shall quote a competitive joint rate or proportional rate if interchange of the traffic is practicable. The quoted rate will be deemed conclusively to meet the "competitive" standard if the carrier's revenue to variable cost ratio for the quoted rate is no greater than the ratio for the carrier's existing joint rate or single line rate. The intent is not to force any carrier to carry traffic at non-compensatory rates, because the carrier's existing joint rate or single line rate can always be set at compensatory levels. In addition, section 10705a protects a carrier from forced participation in a non-compensatory joint rate. Rather, the intent and effect will be to overcome the Commission's poor record and to assure that carriers do not use techniques such as cancelling a joint rate or refusing to quote a joint rate to close off an otherwise practicable and efficient competitive alternative to the shipper or producer.

This section would also modify existing law regarding reciprocal switching and use of terminal facilities, again because the Commission has misconstrued the law. The Commission's current discretion to order such arrangements is changed to a mandatory direction that the Commission shall order such arrangements when it finds they would be either practicable and in the public interest, or necessary to provide competitive rail service. The effect on competition should be salutary, giving a shipper or receiver in a major metropolitan or terminal area the option of choosing between two or more carriers providing efficient line haul service.

Section 10.—Abandonment Procedure.—A railroad line (or other facility) that is proposed to be abandoned is typically a line that is of little interest to the abandoning carrier, perhaps because the line is not profitable. However, the facility to be abandoned is often of great importance to the shippers and communities served by the line. Because the impact on a community and its economy can be devastating, an abandonment decision deserves the most careful consideration. In the opinion of many, the Commission has been too quick to grant many abandonments, often on the basis of poor or incomplete factual records.

The changes in this section make no change in substantive law. The railroad must continue to carry the burden of proving that the line to be abandoned is (1) uneconomic and (2) that the abandonment is in the public interest. This section is intended to give the Interstate Commerce Commission the most accurate record on which to base its abandonment decision, consistent with the obvious need to permit railroads to discontinue service expeditiously on money-losing facilities that lack commitment from the affected communities.

Four procedural changes are made. First, in order to clarify that abandonment proceedings are not to be instruments in a war of attrition, a railroad must wait one year after denial of an abandonment application before refiling to abandon the same facility, unless it can show that circumstances have changed materially since the unsuccessful application was denied. Second, if the abandonment is contested, the Commission must allow a hearing on the impact of the proposed abandonment on community or rural development (the standard set by current law) in one or more of the communities affected. The Commission may contract with outside parties to preside at the hearing, and the railroad proposing the abandonment must pay the expenses of the hearing. Third, the financial data used in deciding whether to permit the abandonment must be based on the revenues from and cost of operating the facility at issue, rather than system-wide or industry-wide averages. Finally, to overcome a railroad practice of surcharging a light density line in order to discourage its use and consequently speed its abandonment, the Commission is directed to disregard any adverse effect of such surcharges.

Section 11.—State Authority.—This section will streamline procedures respecting State jurisdiction over intrastate rail transportation. The fundamental goal of present law is unchanged: a State commission exercising regulatory jurisdiction over intrastate rail transportation pursuant to state law must do so consistently with the provisions of Federal law governing interstate rail transportation. This section would simplify the achievement of this goal by eliminating the time-consuming process of Interstate Commerce Commission certification that a state's law, rules and practices are consistent with the Federal law. Instead, this section eliminates bureaucratic delays and protects the dignity of the state process by relying upon ICC review of state decisions to assure uniformity of implementation. The ICC's review is limited to an appellate function analoguous to that of a court reviewing an administrative agency decision under the Administrative Procedure Act, including a provision for remand of any inconsistent decision to the state agency. The ICC is given 120 days to dispose of any appeal from a state agency decision, thus assuring prompt and effective review.

CONCLUSION

Mr. Chairman and members of the Subcommittee, thank you for directing your attention to the concerns that have been raised with the implementation of the Staggers Act. While we are pleased that the Commission has responded to Congressional pressure in certain captive shipper cases, we are vitally concerned that Congress assure that a sound captive shipper process exists at the Commission for all time. We encourage you to act favorably upon the Consumer Rail Equity Act, S. 676, so that consumers and shippers will obtain the balanced implementation of the Staggers Act that we believe was contemplated in 1980.

Questions of the Chairman and the Answers

REVENUE ADEQUACY

Question 1. The Interstate Commerce Commission has indicated that the revenue adequacy provision in the CURE bill is inconsequential, since even by your own standards, no rail carrier would be considered revenue adequate. What is your response to this?

Answer. We do not know if all rail carriers would be revenue inadequate under the test in the Consumer Rail Equity Act. The General Accounting Office (GAO) concluded in its study last year that under the standards enunciated in the Consumer Rail Equity Act, no rail carrier would be found revenue adequate. That is the only truly independent body that has examined the issue. We do not necessarily agree with the GAO's conclusions, but will assume for purposes of the debate that the conclusions are correct.

For the record, the GAO report did not consider the impact of the $7 billion asset base write-up the ICC will permit in the railroads' transition from betterment to depreciation accounting, nor the implications of the $2 billion in asset base write-downs taken by the railroads in 1986.

If these are taken into account, we believe that several railroads, including the major coal-hauling carriers, would be at or near revenue adequacy. The most important point, then, is that the industry as a whole and several coal-hauling railroads in particular would be viewed—accurately, we believe—as being healthier than the current test shows. If no carrier would be revenue adequate now, the chances are that one or several carriers would in the near term achieve revenue adequacy more quickly under an accurate test. And a carrier at or near revenue adequacy would have less license to change otherwise excessive rates.

In practice, the results are not "inconsequential." One of the rate reasonableness test options of the Coal Rate Guidelines is the proof that a railroad is mismanaged and that our rates would be lower if the railroad were properly managed. The ICC "revenue adequacy" test measures the revenue shortfall which must be attributable to management inefficiency under this test. Thus, the "revenue adequacy" test is anything but "inconsequential" to a captive shipper.

What we seek is accuracy in revenue adequacy determinations, an accuracy that is based upon principles developed in the crucible of proceedings before the nation's public utility commissions and accepted in all fifty states. The Commission chooses to ignore these principles and rely upon a unique set of misleading and inaccurate standards.

We vigorously disagree with the Commission's assertion that since no railroad would be revenue adequate under the test applied by the state commission, the changes we propose would be "inconsequential." Accuracy is never inconsequential. The Commission, instead of presenting a principled defense of its standards, prefers to argue that the differences in results produced by its standards are "inconsequential."

BURDEN OF PROOF

Question 2. The Committee Against Revising Staggers (CARS) has testified that shifting the burden of proof to the railroads to prove rate reasonableness would effectively establish a rate ceiling since railroads could not meet the burden of proof with regard to each of the elements outlined in your bill. Can you tell me what burden you feel the railroads would be called upon to meet and how you view the difficulty of a railroad's meeting this burden under S. 676?

Answer. We do not agree nor intend that our legislation cap rates at any level, let alone at the jurisdictional threshold. Asking a possessor of monopoly power, such as a railroad which a shipper has successfully shown to possess market dominance, to prove the reasonableness of its rate is consistent with sound regulatory principles as practiced before other agencies. In fact, the ICC rate reasonableness process is the only such process in America where the possessor of monopoly power escapes any burden of justifying its rates.

We ask the Commission to explicitly consider just three things. First, the Commission is to consider the railroads revenue adequacy needs. That concept is contained in current law, is the subject of an annual proceeding at the Commission and, as the testimony of the railroad executives before the Subcommittee demonstrates, is a subject which the railroads are capable of addressing most eloquently. Second, we ask that the Commission consider the railroads actual cost of service. If the carriers are as market-driven and productivity-oriented as their testimony would have you believe, this too is a subject on which the railroads already possess ample information and competence to prove. Finally, we ask that the Commission affirmatively examine the Long-Cannon factors, which are designed to prevent captive shippers from paying rates that reflect inefficient pricing and operating practices on competitive traffic. This can hardly be objectionable, since this already provided in current law—it is just not being applied by the ICC. The Long-Cannon factors were a key point of the compromise that allowed the Staggers Act to pass in 1980 and were viewed as an important element of the captive shipper protections in the Act.

Beyond these explicit considerations, the burden of a railroad's proof is within the control of the Commission, which is free to examine any other test, including stand-alone cost. I might add that we are merely shifting to the railroads the burden that is now on us as the captive shipper.

STATE AUTHORITY

Question 3. The National Industrial Transportation League has testified that it fears that Section 11 of the Consumer Rail Equity Act would give states additional authority over intrastate rail matters, a change which it believes could result in deviations from federal standards and which would impose burdensome administrative requirements. What effect do you believe Section 11 would have on rate and administrative requirements?

Answer. We don't agree with the League's characterization. The provisions of the Consumer Rail Equity Act on intrastate authority are designed to ease, not increase, administrative burdens by removing the cumbersome and time-consuming state certification procedures. The legislation continues the current law's requirement that states must regulate intrastate transactions consistently with all federal standards, including ICC rules and decisions. The ICC will act as a reviewing court with full authority to correct deviations from federal standards just as an appellate court corrects agency deviations from the law. We do not believe that this provision will allow for deviations from federal standards nor would it reimpose burdensome administrative requirements.

COMPETITIVE ACCESS

Question 4. What impact do you believe the enactment of "competitive access" provisions standing alone would have on captive shippers? Don't you feel that provisions intended to promote competition within the rail industry could obviate the need for some of the changes you are now promoting in the area of rate reasonableness, for example?

Answer. The competitive access provisions of the legislation are intended to reaffirm the Staggers Act's intent that whenever possible, the forces of competition discipline railroad behavior. Any shipper would readily agree that competition is superior to the expensive and uncertain remedies offered by any regulatory scheme. Thus, to the extent that the Congress chooses to fashion the law to make competition available and prevent captivity to railroad monopoly, there is certainly no need for regulation. We would caution, however, that short of providing trackage rights on shipper demand, there probably always will be at least some captive shippers—and they will need a remedy in law to protect them against unreasonable rail rates.

FIXED COSTS

Question 5. The railroads will testify that legislative proposals to amend the Staggers Act would have the affect of raising rates for customers who currently contribute less to fixed costs than bulk commodities, such as coal. They believe that this will drive these customers away, leaving a larger share of fixed costs to be borne by coal. What is your response to this?

Answer. The railroads essentially argue that they should have the unfettered right to charge a captive shipper whatever they wish and that, somehow, that is in the captive shipper's best interest. That argument was not effective in 1980 and has not found a sympathetic audience with respect to monopoly pricing power anywhere in America since the late 1800's. As it turned out, the railroad executives, the Association of American Railroads and the Wall Street investment analysts unanimously testified, both in the House and Senate, that legislation that moderates captive shipper rates will not have the effect of raising rates on competitive traffic. That is because a rate set by competitive forces cannot be unilaterally raised by the railroad.

Several witnesses did say that since rates could not be raised on competitive traffic, service to those customers would deteriorate and consequently drive those customers off the rails. If this is true, the argument goes, the share of fixed costs these shippers paid will now have to be paid by captive shippers.

The argument is based on three faulty premises and doesn't stand up to scrutiny.

The first faulty premise is that service deterioration is inevitable. It is not. If monopolistic excesses on captive shippers mean a reduction in overall revenues, the railroads can do what most businesses in the competitive environment would do: cut costs. Deferred maintenance and other service deteriorations are where the businessman ends his cost-cutting efforts, not begins them. Improved productivity, plant rationalization and similar efforts can improve revenue and performance. We believe that there is much the railroads can do in these areas. Perhaps having the cushion of excessive captive shipper revenues has sheltered the railroads from pursuing these efforts to the same extent other American businesses have had to do.

The second faulty premise is that when competitive traffic is shed, fixed costs are not shed. That's not correct. Some of the railroads' most competitive traffic is piggyback traffic, which the railroads testified contributes on average just 12% above variable cost. This is the industry's fastest growing segment of traffic and is very capital intensive, such that its fixed costs are significant. If some of that traffic is shed as uneconomic (and we're not necessarily suggesting that it should be), a portion of the industry's fixed costs can be shed as well.

The third, and most important faulty premise is that there is somehow nothing wrong with indefinitely carrying traffic that does not earn a reasonable profit. There most certainly is. Over the short run, the railroads' pricing of piggyback at 112% of variable cost is defensible—assuming that is the best they can do—but over the long run pricing at that level is uneconomic and inefficient. Irrespective of anything that happens to captive traffic, that performance must improve as a matter of ordinary business sense, either by cutting costs and improving productivity or by increasing rates, or both. There isn't anyone in the railroad business or the competitive shipping community that would disagree. In this respect, when the railroads speak of their inability to earn a competitive return in the railroad business, and their consequent "disinvestment," they must be referring to competitive traffic such as piggyback, which does not earn a profit, and not captive traffic, which by definition does.

MARKET DOMINANCE

Question 6. In the version of Consumer Rail Equity Act introduced during the 99th Congress, CURE was willing to accept the agreement negotiated between the Association of American Railroads and the American Paper Institute on the issue of market dominance. This agreement would continue to allow consideration of product and geographic competition, while shifting the burden of proof to the railroads. CURE now opposes any consideration of product and geographic competition. Please explain the rationale or circumstances behind this.

Answer. In accepting the AAR-API agreement, it had been our hope that shifting the burden of proof of product and geographic competition to the railroads would ease the administrative delays and complexities associated with these aspects of the market dominance phase of the rate reasonableness cases. Product and geographic competition have very rarely resulted in a final finding of no market dominance, but the inquiry into these concepts has consumed time and resources far out of proportion to their probative value. Arguments over these types of competition have been a major element in the inordinate delays at the ICC—and the shippers have almost always won in the end.

I am told that the *McCarty Farms* grain farmers' case, for example, featured the submission of thousands of pages of evidence on product and geographic competition, and the Commission needed nearly seven years to find that no effective product or geographic competition existed. So even after the AAR-API compromise was adopted, the Commission's ability to resolve these issues expeditiously did not improve. In fact, during the last few months, a Federal Court of Appeals has overturned one ICC finding in this area and the ICC has reversed itself in two other cases. In each case, more than two years had elapsed before the initial decision was overturned. Thus, we believe time and experience have shown that the probative value of these inquiries does not justify the cost and delay they produce.

CASES FILED

Question 7. Chairman Gradison of the ICC has testified that in 1986 only three rail rate cases were filed at the ICC and that none have been filed in 1987. In her view, this indicated that shippers are generally satisfied with their rail rates and that this argues against the need for enactment of the Consumer Rail Equity Act. What is your response to this?

Answer. My initial reaction is that those were three brave—or desperate—parties that decided to file rate complaints in 1986. Most other shippers, including my company, came to the conclusion some time ago that it would be an exercise in futility to pursue a rate case at the ICC, and so we settled what complaints we had on the best terms we could get. Many of us made major investments to escape or avoid captivity. While my ratepayers will certainly benefit over the long term from the investments, I question whether society's resources are being wisely allocated when shippers are forced to spend substantial sums to construct alternatives to rail monopoly because they can't get relief from an agency that is supposed to prevent abuses of monopoly power.

The ICC's record of carrying out the captive shipper protections of the Staggers Act has been poor by any standard. That is why no one pursues cases at the Commission anymore. My customers are paying for this regulatory indifference, and that is not right.

QUESTIONS OF SENATOR ROCKEFELLER AND THE ANSWERS

Question 1. You testified that the use of stand-alone cost applied to your utility companies would result in significantly higher electrical rates. Please explain.

Answer. It is really very simple. Stand-alone cost, as I understand it, requires a shipper to replicate a competitor railroad at today's costs, while the actual railroad that charges the rate under review was built over time, at historical costs much lower than current costs. No matter how much discretion a shipper is given at the ICC in developing and costing out this hypothetical railroad, he can never overcome the significant disparity between current and historical costs.

Commissioner Brown of the Ohio Public Utilities Commission testified just before I appeared before the Subcommittee. He said that my company would prefer to have its rates based on stand-alone cost. He is right. My company's physical plant, which was built at a cost of about $15 billion, would cost at least $75 billion to replicate at today's costs. I don't understand how a rate reasonableness test that requires the shipper to substitute current costs for historical or actual costs produces a fair and objective result. That is why we would propose that the ICC at least examine the actual cost in judging rate reasonableness.

Question 2. How do you respond to the contentions of the Association of American Railroads that utilities seek to have their health measured by the cost of capital standards that the railroads support, and that by and large the utility business is healthier and more profitable than the railroad industry?

Answer. C.U.R.E. has never disagreed that the railroads should have their financial health measured fundamentally by their ability to earn the cost of capital on their investment base. The disagreements have been over how the investment base is measured and how the cost of capital is calculated. Over the years, the nation's state public utility regulatory commissions have developed a large and impressive body of expertise and experiencing in administering the cost of capital test, and they have arrived at a general consensus on the basic principles. The ICC doesn't follow these basic principles and the result is that its test overstates railroad revenue needs.

I am told that the reason the ICC gives for following different principles is that the railroads' traffic and rates are mostly competitive and deregulated. I don't believe that that is a meaningful distinction, for revenue adequacy measures a company's ability to compete for capital, not traffic. My company and the railroads must compete in the very same capital markets, so measuring our ability to compete in those markets by very different tests is, it seems to me, difficult to defend.

As to the argument that by and large the utility business is more profitable than the railroad business, I would offer two comments. The first is that it is irrelevant: by law and regulation, my ratepayers, not my shareholders, bear all of the burden of paying for excessive rail rates and receive all the benefits of any rate reductions we can obtain. Electric utility rates and returns on investment are regulated by a very strict regulatory process that no one is contending should be applied to the railroads. The second comment is that averages prove nothing in a debate over whether the minority of shippers who are captive have a fair, balanced and impartial forum at the ICC to protect against abuses of railroad monopoly power.

Question 3. How do you respond to the contentions of the Federal Railroad Administration that the small number of captive shipper complaints in comparison to the large number of tariff and contract filings does not support your argument that railroads are systematically abusing captive shippers without any relief from the ICC?

Answer. I wish the Federal Railroad Administration were correct, but that is not the case. The virtual absence of any complaint filings at the ICC is due mostly to the fact that it requires seven or eight years, a million dollars or more, and perhaps a scheduled Congressional hearing for the ICC to finally dispose of a rate reasonableness case. Moreover, there is no reason for any party to pursue a rate complaint at the ICC when the Commission has no clearly articulated, predictable test for rate reasonableness.

I will say this, though. No party will readily resort to litigation, either at the ICC or in a court, if it has any alternative. That is particularly true where the dispute is with a major customer or major supplier with which the party must conduct an ongoing business relationship. We at AEP strive to avoid litigation and attempt every remedy or solution short of litigation, and that is how most businesses conduct themselves. No matter how the law is changed, then, Congress should not anticipate a sizeable increase in the ICC's caseload, especially since most traffic will continue to be deregulated. What we seek in the Consumer Rail Equity Act is what Congress attempted to provide in 1980—a balanced, fair process for rate reasonableness review at the ICC for use when all else fails.

QUESTIONS OF SENATOR DANFORTH AND THE ANSWERS

Question 1. Dr. Mark Cooper of the Consumer Federation of America testified before the Surface Transportation Subcommittee that the CURE bill may move the railroads toward becoming an industry that serves only bulk commodity shippers. If so, what does this mean for other shippers? Will railroads abandon lines?

Answer. We disagree that passage of S. 676 or other Staggers Act reforms would transform the rail industry into a system that serves only bulk commodities, nor do we think the national interest would be served by such a change. We don't disagree, though, that the rail system is likely to continue to shrink in some measure—the railroad CEO's so testified at the Subcommittee's hearings—and that railroads ought to be permitted to abandon truly uneconomic lines that don't serve any public interest.

The rail industry is no more immune to the demands and challenges of competing in the 1980's than any other business. Improved productivity and efficiency are the keys to our nation's long-term competitiveness, and while the railroads have made substantial progress in these areas, no one would argue that they can't do more. It may well be that unreasonably high rates on captive traffic have provided the railroads with enough of a cushion to avoid making their best efforts, but we have no way of knowing for sure because the Commission won't enforce the Long-Cannon amendment.

Competitive shippers should receive the rail service they are willing to pay for, no more and no less. The marketplace is capable of making the decisions as to rates and service that lead to the best and most efficient use of society's resources, but only so long as the marketplace is not distorted by regulatory indifference to monopoly power and its abuses. That is why Congress retained the ICC in enacting the Staggers Act and gave it the responsibilities contained in the Long-Cannon amendment.

Question 2. CURE's proponents argue that the competitive access provisions of the CURE bill are designed to encourage competition. Why don't these provisions permit the ICC to consider truck or barge competition in deciding whether to order competitive access?

Answer. As with product and geographic competition in the market dominance setting, there may theoretically be nothing wrong with considering effective truck or barge competition in certain competitive access proceedings. But just as the Commission has had great difficulty resolving the complexities of product and geographic competition in market dominance disputes, the Commission has also tended to use theoretical truck or barge competition as barriers to properly considering competitive access complaints. Let me assure you that a shipper with real and effective truck or barge alternatives will not waste time and money pursuing a competitive access complaint at the ICC.

Question 3. Much of the controversy that has led to the introduction of the CURE bill has centered on the railroads differential pricing. That is, railroads charging captive customers higher margins above cost than non-captive customers. Do utilities have customers which have alternatives to using utilitity as a source of power (e.g., gas vs. electric heat)? Do you charge these competitive customers lower rates than your captive customers?

Answer. The Staggers Act provides for differential pricing, and we don't seek to eliminate it. Specifically, captive shippers must pay a minimum of 180% revenue to variable cost ratio (whereas competitive traffic usually pays below 150% revenue to variable cost) and a maximum of "reasonable", that is to be determined by the ICC. It is not differential pricing that led to the introduction of the Consumer Rail Equity Act, but rather the lack of a fair and balanced process at the ICC for determining what is a "reasonable" rate.

As to the electricity pricing policy of the states, it varies from state to state. As a general proposition, large industrial users or others with competitive alternatives to electricity are not charged discount electrical rates. In a few states, most notably California, state commissions are beginning to allow this practice in certain selected cases, but it is not widespread. In any event, any such discount must be submitted to, examined by and approved by a state utility commission appointed by a Governor or accountable to the voters.

Let me repeat CURE's often-repeated disclaimer that we do not oppose railroad differential pricing, we do not seek to end railroad differential pricing, and do not support legislation that would end railroad differential pricing. Under current law and under our legislation, captive shippers and their customers would continue to bear the disproportionate share of helping sustain a sound and viable national rail system. We retain the current jurisdictional threshold, we retain the requirement that the complaining shipper must prove that it is subject to railroad market dominance and we retain the complete freedom to contract.

Question 4. Section 3 of the Consumer Rail Equity Act would preclude consideration of product and geographic competition. It seems that this provision would vastly expand the rate regulation jurisdiction of the ICC since thousands of potential litigants that now refrain from brining cases because they cannot be sustained due to the existence of product or geographic competition would be able to seek regulatory intervention. Is that correct?

Answer. No. for several reasons. First, if shippers truly have product and geographic alternatives, they are in all likelihood paying rates below the jurisdictional threshold at the ICC. I would seriously question that there are thousands of people with product and geographic options that are paying rates over 180% of variable cost when competitive rail rates are usually below 150% of variable cost.

Second, the ICC has denied market dominance on the basis of product and geographic competition in very few cases.

Third, the question presupposes that "thousands" of shippers who in fact possess real and effective product or geographic alternatives to monopoly rail rates would prefer to spend hundreds of thousands of dollars on attorneys and consultants to try to win a rate case at a Commission with the record this one has compiled, instead of simply using those alternatives or at least negotiating with the railroads. As an executive who has been faced with just that choice, let me assure you that is not the case.

Finally, section 229 of the Staggers Act bars anyone from now bringing a case against a rate that was in effect at the time the Staggers Act was passed so long as the rate does not exceed the increases allowed by the Rail Cost Adjustment Factor. Thus, the railroads' argument that rates have come down since the Staggers Act directly conflicts with their claim that eliminating product and geographic competition as a threshold finding somehow frees "thousands" of shippers to file rate complaints.

Question 5. Pursuant to 49 U.S.C. 10505, the ICC may grant an exemption only when it determines that (1) regulation is not necessary to carry out the national transportation policy and (2) the transaction is of limited scope or regulation is not necessary to protect shippers. Section 8 of the Consumer Rail Equity Act would provide that, having made those findings, granting the exemption should be permissive. What is the purpose of making an exemption permissive when all of the requisite findings have been made?

Answer. The Commission has relied upon the present law's language that an exemption "shall" be granted if the predicate findings are made as an excuse to grant blanket exemption based on aggregate or average numbers, while promising that individual cases of abuse can be dealt with on a case-by-case basis of partially revoking the exemption. Since the Commission has shown itself to be incapable of handling even the relatively small number of rate cases on its docket, that is a hollow promise. I am told that to date, no party has successfully persuaded the Commission to partially revoke any exemption, which would be a two-step process: first, prove that the Commission should partially revoke, and second, prove the elements of a case under the relevant remedial provisions of the law.

Therefore, S. 676 changes the word "shall" to "may" to clarify that Congress does not intend for the Commission to embark upon a wholesale elimination of regulation, regardless of the impact on a minority of individual shippers.

Question 6. In 1985, the electric utilities presented this Subcommittee with 19 cases of alleged abuse of shippers by the railroads. The Department of Energy looked into those cases and concluded that there was no abuse. Have there been any additional cases since then that you could cite?

Answer. I should point out that the Department of Energy's ultimate "conclusion" that railroads were not abusing the captive shippers in those identified cases was fatally flawed by its refusal to examine the railroads' costs of serving the shippers in question. On the basis of some moderate rate decreases and some moderate rate increases, the summary of the Department's study (although not the body of the study) concluded that there where no present abuses. But railroad costs have declined significantly since the Staggers Act was passed, as ample testimony before the Congress has demonstrated, so little or no change in rail rates means that railroad profitability has improved significantly since the Staggers Act, a fact not reflected by the ICC's flawed revenue adequacy test.

Beyond that, we would note that the DOE's draft study (which was never issued in final form) severely criticized most of the same aspects of the ICC's implementation of the Staggers Act which we are attempting to remedy. The DOE's study agreed, for example, that the use of product and geographic competition "greatly adds to the cost and complexity of the (market dominance) analysis, often with little or no gain in the precision of the findings." (Page V-5.) The DOE's study agreed that the ICC's revenue adequacy test was flawed: it found that if the ICC's revenue adequacy test were applied to a utility (Pennsylvania Power & Light Company was the example the DOE chose), the utility would be allowed to earn 20 percent more revenue than its state commission allowed. (Pages V-31 to V-34.) The DOE's study identified a number of problems with the ICC's use of stand-alone cost, many of which are still not resolved. (Pages V-34 to V-49.) The DOE study, in short, is anything but a defense of the policies adopted by the ICC under the Staggers Act.

Question 7. You suggest that the ICC should regulate more like a public utility commission does. In your rate cases, does a utility have to prove it deserves to earn the cost of capital on its rate base?

Answer. Absolutely. Every penny in our utility investment base is scrutinized by the state commissions to ensure that it is properly accounted for and properly includable as a cost of providing electrical service, and our debt and equity expenses are rigorously examined. If a utility company is inefficiently managed, makes poor purchasing or investment decisions, fails to properly hold its expenses down, or does anything but provide efficient service at the lowest cost, it is penalized by having assets removed from investment base, by having claimed expenses disallowed, or by being allowed a reduced rate of return. There are no guarantees in the utility business, other than the guarantee that a poorly run business will not be allowed a competitive rate of return needed to attract and retain capital.

We don't, by the way, seek to have railroad investment base, cost of capital, or monopoly rates held up to this kind of scrutiny. We only ask that certain fundamental principles that have become benchmarks of rational regulation in all fifty states be observed where practicable and applicable in ICC proceedings.

Senator EXON. Thank you.

Mr. Zitto.

Mr. ZITTO. Thank you, Mr. Chairman. I appear today on behalf of the Procompetitive Rail Steering Committee. Our committee is composed of major industrial companies which are very dependent on railroads to transport our raw materials and manufactured products. We founded the Procompetitive Committee in 1983 to preserve and promote rail-to-rail competition when it became clear that the ICC would do nothing about massive cancellations of joint rates and reciprocal switching by the large railroads.

I want to stress that we strongly support the Staggers Rail Act. It is a good piece of legislation, and we are not reregulators. Our problem is with the ICC's failure to implement the procompetitive policies of the Act in a fair, responsible manner. My testimony explains in detail why the large railroads have reduced rail-to-rail competition and how that action adversely affects rail dependent shippers in the public interest.

This problem becomes even more critical with the unprecedented wave of mergers and consolidations in the railroad industry. Today, 85 percent of rail operating revenues are controlled by seven railroads, but what is more germane to these hearings is the ICC's adamant refusal to take any action that will encourage railroads to compete with each other for captive or rail dependent traffic. Two recent decisions vividly illustrate this ICC attitude.

In the Midtec case, the ICC, after four years of litigation involving two separate decisions, not once but twice refused to grant Midtec reciprocal switching and terminal trackage rights. It held that a shipper must assume virtually the same burden as a complainant in an antitrust case before obtaining access to a competing railroad.

On September 23, 1986 the ICC, after five years of litigation, found Conrail's July 1981 blanket cancellations of joint rates and routes to be illegal, but to add insult to injury the ICC let Conrail retain all the benefits of these illegal cancellations and merely ordered Conrail and protesting shippers to negotiate new joint rates.

Our experience with the Interstate Commerce Commission and the railroad industry over the last five years has convinced us that greater rail-to-rail competition is absolutely essential to insure the success of rail deregulation under the Staggers Act. We are also convinced that Congress can no longer leave the implementation of rail deregulation to the ineptitude and administrative meanderings of the ICC.

Section 9 of Consumer Rail Equity Act entitled Enhancement of Competition contains provisions long advocated by our committee. These provisions direct the ICC to approve reciprocal switching and joint line rates to create increased competition among railroads. The railroads have responded to this legislation with scare stories of reduced revenues, service cutbacks and railroad bankruptcies.

These prior predictions ignore the incentives which competition provides for increased efficiency, lower cost, technological innovation and growth in market share and profits. In such an environment, efficient railroads will grow and prosper.

Mr. Chairman, the Procompetitive Rail Committee thanks you for this opportunity to present its views and looks forward to working with you and the other members of the Committee in addressing the problems outlined.

[The statement and questions and answers follow:]

STATEMENT OF FRED M. ZITTO IN BEHALF OF PROCOMPETITIVE RAIL STEERING COMMITTEE

My name is Fred M. Zitto. I appear for the Procompetitive Rail Steering Committee (PCRSC), which I serve as President. I am the Manager of U.S. Distribution Operations for International Paper Company. My business address is 6400 Poplar Avenue, Memphis, TN 38119.

I. BACKGROUND AND POSITION OF THE PROCOMPETITIVE RAIL STEERING COMMITTEE

PCRSC is an association comprised of widely diversified companies which operate facilities throughout the United States which are substantial users of railroad transportation. The following companies are members of PCRSC:

Amoco Chemicals Company.
Cargill Incorporated.
Ethyl Corporation.
FMC Corporation.
ICI Americas, Inc.
International Minerals and Chemicals Corp.
International Paper Company.
Libbey-Owens-Ford Company.
Manville Service Corporation.
Olin Corporation.
Owens-Illinois, Inc.
PPG Industries, Inc.
Reichhold Chemicals Inc.
Union Carbide Corporation.
Wyandot Dolomite, Inc.

PCRSC was formed in 1983 by a number of large industrial companies which are tied to the railroads by production facilities designed for rail service and by distribution systems characterized by long-distance, high-volume shipments which generally cannot be economically transported by truck or intermodal service. The dependence of our members on rail service cannot be altered without signficant increases in capital investment and unacceptably high operating costs. Many of the products shipped by members of PCRSC are fungible, bulk, low-value goods for which rail transportation costs represent a significant percentage of delivered value. Accordingly, the members of our Committee are vitally interested in any legislative measures which will facilitate and promote increased rail-to-rail competition and preserve competitive transportation markets.

II. PCRSC DOES NOT SEEK FURTHER REGULATION

Many of our members, encouraged by the Congressional emphasis on competition as an alternative to pervasive regulation of the railroads, were strong supporters of the Staggers Rail Act of 1980. However, the Interstate Commerce Commission has failed to achieve the proper balance between railroad and shipper interests contemplated by Congress. Our problem is not with the Staggers Act, which has worked well where rail-to-rail competition exists. Our problem is the Interstate Commerce Commission's failure to implement responsibly the procompetitive provisions of the Act.

Over the last several years, PCRSC has forcefully advocated the necessity for increased rail-to-rail competition to eliminate shipper captvity. We have discussed the need for competitive rail access with the Association of American Railroads and the railroads which serve our facilities. We have met with opposition, delays, litigation, and protracted administrative excursions before the Interstate Commerce Commission. We have been accused of being "reregulators" and our proposals have been denigrated by the AAR in an advertising and public relations campaign of unprecedented proportions.

Simply stated, PCRSC does not seek additional ICC rate regulation. We want rail competition, not rate regulation, to govern rail rates. We do not want lower rail rates, we want competitive rail rates and competitive service. We also insist that the ICC administer those regulatory responsibilities with which it was entrusted by the Staggers Act in a fair and even-handed fashion.

These are modest and reasonable legislative objectives which merely address the ICC's failure to implement the existing provisions of the Staggers Act. They do not expand regulatory jurisdiction into new areas or repeal the competitive principles of the Staggers Act. The attempt to characterize the Consumer Rail Equity Act and its competitive access provisions as "reregulation" is a self-serving canard conceived by the railroads to restrict competition and to perpetuate their monopoly power over captive shippers.

III. JOINT RATES, RECIPROCAL SWITCHING, AND/OR TERMINAL TRACKAGE RIGHTS MUST BE AVAILABLE TO PROMOTE RAIL-TO-RAIL COMPETITION

The concept of competitive access involves the system by which a railroad transports a shipper's freight to and from points beyond the physical limits of that railroad's tracks. This concept reflects the highly interdependent nature of railroad transportation which requires the physical interchange of freight cars from one carrier to another as the shipment moves from origin to destination.

In order to fully understand the competitive access problem, the following basic definitions and illustrations are useful:

A. Definitions

1. *Single Line Rate.*—A rate applicable from one point on a rail line to another point on the same rail line.
2. *Joint Rate.*—A rate applicable from an orgin on one rail line to a destination on another rail line which is divided among all railroads involved in the movement.
3. *Reciprocal Switching.*—The movement of cars for compensation between a railroad that actually serves a particular shipping facility and a railroad that physically serves the market area but not the particular facility served by the switching carrier.
4. *Trackage Rights.*—An arrangement in which one railroad leases its tracks to another, thereby enabling the other railroad to directly serve a terminal area or specific point which it could not otherwise reach over its own rail lines.

B. Illustrations

1. Joint rates and routes

Imagine the Washington Metro, not as a single system, but as a collection of separate rail lines. The Red Line is the Red Railroad, the Blue Line is the Blue Railroad, and so forth. If you get on the Red Railroad at Silver Springs and travel to DuPont Circle, you fare is a single line rate. No other rail lines are involved. Applying that definition, if a company ships a trainload of grain from St. Paul to Seattle via the Burlington Northern—and no other railroad—that company pays a single line rate.

Returning to our Metro example, assume you want to travel from Silver Springs to a point not served by the Red Line—such as Rosslyn. This is a joint movement requiring the agreement of both the Red Railroad and the Blue Railroad to take you from the origin to the destination for a specific rate. That rate is your joint rate. With respect to PCRSC members and many other shippers, joint line hauls are the norm. Many shippers regularly move commodities from origins served by one railroad to destinations served by different railroads, all in response to the signals the marketplace sends us. These origins and destinations are not connected by neat, simple single-line rail service. For example, a tank car of corn syrup moving from a plant in Cedar Rapids, IA, to Philadelphia would move via the Chicago & Northwestern Railroad to Chicago and then via Conrail to destination. Paper products moving from the Pacific Northwest to the East Coast may move via the Southern Pacific and Conrail. Fertilizer mined in Florida and destined for the Midwest could move via the Seaboard Line and the Santa Fe. Chemicals from the Gulf Coast bound for the Northeast may move via Norfolk Southern and Conrail. These movements all require joint rates.

All well and good, you say, but what is the problem? Simply stated, an individual railroad understandably will want to keep as much traffic for itself as it can, even if its single-line route to destination is not the most direct for the shipper. Since 1980, many railroads have eliminated economic joint routes in order to keep traffic on single-line, long haul routes which generates the greatest revenues. This action frequently eliminates alternative competing joint routes and thereby reduces rail-to-rail competition. The situation is exacerbated by the proliferation of rail mergers during the past several years. And without rail-to-rail competition the whole national rail network loses efficiency, becomes less responsive to market signals, and distorts the competitive benefits intended to be provided through railroad deregulation.

2. Reciprocal switching

Turning next to reciprocal switching, let us again refer to our Metro example. Suppose the Red Railroad and the Yellow Railroad and all the others run to different cities. And suppose the Capitol Beltway represents the boundary of the Washington switching area. Trains running from the Beltway to another city would be a line haul movement. Anything within the Beltway would be a terminal movement. A line haul movement involves trips from city to city, while a terminal movement is within a limited terminal area.

Reciprocal switching agreements between railroads are designed to open access to terminal facilities. Without them, many rail shippers would be cut off from railroads serving the shipper's suppliers and customers. In these arrangements, the serving railroad sets a charge for the switching service and publishes this rate in a switching tariff. These charges may be absorbed (i.e., paid) totally by the line haul carrier, or a part of the charge may be passed on to the shipper.

But what has this to do with competitive access? Simply stated, it means that reciprocal switching can be used as a means of controlling traffic among rail lines. That is, if the Red Railroad refuses to establish a switching tariff, shippers have no means of moving from Red Railroad origins within the terminal switching district to destinations on Yellow Railroad line haul routes. In situations where the Red Railroad and Yellow Railroad both serve a plant in another city, the Red Railroad's refusal to switch to the Yellow Railroad will eliminate the Yellow Railroad's ability to compete for the traffic to that plant originated by shippers within the terminal area served by the Red Railroad. Or, if the Red Railroad decides to participate in a switching arrangement, it may establish a charge so unrealistic as to effectively close off access to the Yellow Railroad points as well. Either way, shippers are denied access to markets via competing rail lines.

Several examples illustrate the problem. In 1980 Conrail assessing a switching charge of $180 a car at Dayton, OH. In 1986, the Conrail switch charge in Dayton, OH, had increased to $299 a car. In Memphis, TN, the ICG switching charge was $237 a car, whereas the Burlington Northern and Mopac switching charges were only $60–$97 a car. In Denver, CO, the pre-Staggers Act switching charge level was approximately $105 a car. By 1986, the switching charge was $400 a car. It is axiomatic that if a railroad sets its reciprocal switching charges at high, unrealistic levels, little or no traffic will be moved.

3. Terminal trackage rights

As an alternative to reciprocal switching, trackage rights can be used to allow the non-serving railroad to use the serving railroad's tracks. In the example noted above, the Yellow Railroad would obtain trackage rights over the Red Railroad in order to serve the shippers physically located on the Red Railroad's lines within the terminal area. Under this agreement, the rates and tariffs used by the Yellow Railroad would apply to shippers on the Red Railroad lines to the same extent as shippers on the Yellow Railroad. No additional switching charges or absorption charges are involved. Instead, the Yellow Railroad would pay the Red Railroad a lease charge for using its tracks.

The difference between reciprocal switching and trackage rights is important. If a carrier will not realistically price its switching services in order to allow open competitive access, then that carrier should allow other railroads the right to serve directly those shippers located within the terminal at a reasonable price. Without this basic tenet of competitive access, railroad deregulation simply cannot provide the efficient, responsive rail system envisioned by the Staggers Act.

IV. THE ICC HAS CONSISTENTLY REFUSED TO PROMOTE RAIL-TO-RAIL COMPETITION

The ICC's steadfast resistance to promoting and enhancing rail-to-rail competition has been described in detail for the Congress during the 1985 Staggers Act oversight hearings and the hearings conducted last year on the Consumer Rail Equity Act. No useful purpose will be served by reciting a litany of the ICC's decisions which reflect its dismal record in competitive access cases. However, there is attached as Appendix B [1] a representative summary of ICC decisions and orders over the past several years which demonstrates the Commission's complete disregard for the clear Congressional policy favoring rail-to-rail competition.

The railroads have responded to the Commission's regulatory derelictions in the competitive access area by filing wholesale joint rate cancellations, reciprocal switching cancellations, etc. There is attached as Appendix C a representative summary of competitive foreclosure actions taken by every major railroad between 1981 and 1983, consisting of joint rate cancellations and reciprocal switching cancellations or increases. Appendix C describes for each named railroad the nature of the foreclosure action and the ICC response to that action. It should be noted that in all of the cases except one,[2] the ICC neither suspended nor even investigated the cancellation publications.

Two proceedings vividly illustrate the Commission's inept and hypocritical approach to competitive access and its snail-like handling of such cases. The first is Docket No. 38676, *Changes in Routing Provisions—Conrail—July 1981,* 365 I.C.C. 753 (1982), rev'd.; *Chesapeake & Ohio Ry. Co.* v. *U.S.,* 407 F 2d. 323 (7th Cir. 1983); *Changes in Routing Provisions—Conrail—July 1981,* Docket No. 38676 (Decision served September 23, 1986), which involves Conrail's 1981 blanket cancellations of interterritorial joint rates and routes. In this unprecedented action, Conrail published wholesale cancellations of its joint rates and routes and in doing so admittedly diverted approximately $50,000,000 from competing railroads to Conrail. This proceeding which was initiated in 1981 is still in litigation today, some six years later. In the interim, the joint rates and through routes have long since been cancelled and the shipping public continues to suffer the consequences of Conrail's action.

The Commission's procedural handling of the case is an administrative nightmare and a legal travesty. The complete ineptitude with which the Commission handled the case is demonstrated by the chronological history of the proceeding which is set forth in detail in Appendix D.

The Conrail route closings case began in June of 1981 when Conrail published wholesale cancellation of joint rates and through routes. The Commission's response was to investigate, but not to suspend, the cancellations. On appeal from the Commission's 1982 decision approving the cancellations, Judge Posner of the Seventh Circuit U.S. Court of Appeals characterized Conrail's action as a "meat ax" approach and severely criticized Conrail's efficiency studies. The Judge was also critical of the Commission's failure to accord protestants adequate opportunity to examine the computer tapes and evidentiary materials submitted by Conrail in justification of the cancellations. The court remanded the decision to the Commission, ordering Conrail to justify the claimed efficiency benefits of its cancellations on a comparative route-by-route basis.

In 1983, after pressure by protestants, the ICC reopened the proceeding and in early 1984, Conrail submitted a massive computer-generated routing study to support its cancellations. Once again, protestants were forced to litigate the issues for almost nine months in order to obtain necessary discovery of Conrail's computer tapes and underlying documents to evaluate this new evidentiary material. Finally, protestants were able to obtain sufficient discovery to determine that Conrail's computer-generated efficiency studies were wholly inadequate and misleading. Protestants filed evidence of this fact with the ICC in December 1994.

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[1] The appendixes were not reproducible and are in the Committee files.

[2] *Changes in Routing Provisions—Conrail, July 1981* in which the Commission did not suspend but investigated the cancellations and which case continues to be litigated approximately six years later.

Over a year and a half later, in a decision issued on September 23, 1986, the Commission, on remand from the U.S. Court of Appeals, found that Conrail had not established that its preferred, long haul routings were at least as efficient as the joint line routings which it had cancelled. The ICC concluded that Conrail's 1981 cancellations of joint rates was contrary to the public interest. However, the ICC did not order Conrail to rescind its cancellations or to reestablish joint rates over efficient routes. Instead, it simply directed Conrail and protesting parties to enter into negotiations to establish joint rates consistent with the Commission's newly adopted competitive access regulations.

Thus, after five years of protracted litigation, and an evidentiary record which demonstrated that the cancellations were not efficiency based, the Commission left Conrail's entire blanket rate and route cancellations intact and simply ordered the protesting parties to negotiate with Conrail for the reestablishment of new rates and routes. In effect, the Commission's decision permits Conrail to retain all the benefits of blanket rate and route cancellations found to be unlawful.

Significanly, during the course of this litigation, Grand Trunk Western filed an antitrust suit which it favorably settled in April, 1986. The Delaware & Hudson Railroad Company in presently pursuing a similar antitrust suit against Control in the U.S. District Count in Albany, NY.

The second case, Finance Docket No. 39021, *Midtec Paper Corporation* v. *C & N W Transportation Co.*, 1 I.C.C. 2d 362 (1985), —— I.C.C. 2d —— (1986), is another egregious example of the Commission's failure to promote competitive access through reciprocal switching. This case, originally initiated in 1983, sought reciprocal switching and terminal trackage rights to enable the Soo Line Railroad Company to provide competitive rail service to the Midtec Paper plant in Kimberly, WI. The Administrative Law Judge who first heard the case determined that the Soo Line should be granted both reciprocal switching and/or terminal trackage rights to provide competitive rail service. A Commission Review Board granted only reciprocal switching relief. This decision, however, was overturned by the full Commission, which reversed an earlier procompetitive precedent in ICC Finance Docket No. 29802, *Delaware & Hudson Railroad Company* v. *Conrail*, and held that before a shipper is entitled to competitive access relief it must show that the serving railroad had market dominance over its traffic.

The Commission's decision was appealed to the U.S. Circuit Court of Appeals for the District of Columbia, but before the court could hear the case the ICC petitioned the court to return the case for further consideration under the new competitive access regulations adopted by the Commission in Ex Parte No. 445 (Sub-No. 1), Intramodal Rail Competition. The court permitted the Commission to reconsider the case and directed expedited hearings. Those of us who have long advocated increased competitive access were hopeful that the Commission would use this opportunity to construe its new regulations in a positive, procompetitive manner. However, on December 16, 1986, the Commission issued its second opinion in the *Midtec* proceeding, refusing once again to grant Midtec access to competitive rail service.

Most distressing, however, was the manner in which the Commission applied its new rail competition regulations. In its decision, the ICC faulted both Midtec and Soo Line for failing to present extensive evidence of comparative costs, revenues, efficiencies, and competitive impacts during the expedited 90-day proceeding. The Court granted the ICC's remand motion on July 11, 1986. The Commission waited until July 24, 1986 to serve its procedural order on Midtec and Soo Line and then directed the submission to new evidence under the Ex Parte 445 (Sub-No. 1) rules in 20 days with no extensions to be granted. The ICC then concluded that the parties had failed to show any anticompetitive abuse by C&NW., the only grounds on which competitive access could be granted under the new regulations.

In fact, the Commission's decision went far beyond the relief espoused by the C&NW. In effect, the ICC applied its new competitive access regulations in a manner which required the parties to prove an antitrust case in 20 days in order to justify competitive access relief. In sum, the Commission clearly refused to apply its new rules in a manner that would affirmatively expand competitive rail service.[3]

It is worth noting that this is precisely the fear which many shippers and regional railroads expressed to the ICC during the course of the Ex Parte 445 (Sub-No. 1) rulemaking proceeding. Moreover, the ICC's interpretation of the competition access regulations, which was strongly advocated by the AAR and its railroad members, is completely contrary to the understanding and spirit of the competition access agreement negotiated by AAR, National Industrial Transportation League, and Chemical Manufacturers Association which formed the basis for the Commission's competitive access regulations.

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[3] The ICC's restrictive interpretation of these competitive access regulations was judicially upheld on April 21, 1987, in *Baltimore Gas & Electric Co.* v. *I.C.C.*, No. 85-1761, —— F. 2d —— (D.C. Cir., 1987).

The ICC's implementation of its competitive access regulations has been at best disappointing. It appears that the ICC has used the regulations to review recently proposed rate cancellations, but has done nothing to restore competitive joint rates and routes which it permits to be cancelled from 1981 to 1985. In this respect, the ICC regulations are like correcting safety violations on a freight engine after it has run into a passenger train. As illustrated by both the *Conrail—July 1981* and the *Midtec* cases, the ICC simply refuses to promote or expand rail-to-rail competition in an affirmative manner as required by the Staggers Act.

Thus, it is clear beyond dispute that a majority of the Interstate Commerce Commission is either unwilling or incapable of implementing the procompetitive directives of the Staggers Rail Act. The Commission has had repeated opportunities to correct its mistakes, to develop and apply new regulations, and to work with affected parties in arriving at reasonable solutions. Yet time after time, despite lip service to the concept of rail competition, the Commission has refused to recognize, protect, or promote rail-to-rail competition in specific cases. Words cannot express the frustration and growing anger with which shippers view the conduct of the railroads and the policies of the Interstate Commerce Commission on competitive access issues. To quote the famous movie line, "We're mad as hell, and we aren't going to take it any more."

V. COMPETITIVE ACCESS PROBLEMS CONTINUE TO PLAGUE RAIL-DEPENDENT SHIPPERS

It has been our experience that attempts by various shippers to negotiate combination or proportional rates (in place of joint rates) with cancelling carriers via intermediate junctions, have met with resistance not only from cancelling carriers but also from the connecting railroads. The latter have been very reluctant to quote rates beyond interchange points which would provide a competitive through rate. The obvious reasons for such reluctance is a fear that if the connecting carrier quotes competitively, it will invite retaliation by the cancelling carriers to quote competitive proportional rates against it which would result in the loss of its own preferred long haul routings. These cancellations and refusals to quote competitive rates have resulted in de factó market allocations among the large railroads.

I am personally familiar with this problem since it is currently before the Commission in Finance Docket No. 29720 (Sub-No. 2), *Canadian National Railway Company—Trackage Rights in Maine,* and Finance Docket No. 29772, *Guilford Transportation Industries, Inc.—Control—Delaware & Hudson Railroad Company,* a case which involves my company. In this proceeding, International Paper Company is seeking to obtain a competitive joint line rate from Guilford Transportation Industries via the Springfield Terminal Railway, a Guilford subsidiary, which recently replaced the Maine Central Railroad as the only railroad serving our Androscoggin (Riley's), ME, paper mill. During 1986, International Paper shipped some 3,600 rail cars via the Guilford system. Of these shipments, 3,000 cars moved from the Riley's ME mill. In the past several years, despite our support for the creation of the Guilford system, we have been unable to come to an agreement with Guilford on competitive service and price arrangements needed to reach our Midwestern customers via a Guilford-Danville Junction-Canadian National route.

This is an extremely efficient route, with transit times to Chicago averaging four days. We often experience eight days in transit time for Guilford to reach its connections in Buffalo, NY. Despite this, Guilford has refused to negotiate competitive agreements via its efficient interline route with Canadian National. Guilford has continued to handicap CN's efforts to provide us with competitive pricing by adamantly insisting on maintaining a division of revenue in excess of $1,100 per car for a 60-mile haul from our Riley's, ME, mill to Danville Junction. This unconscionable divisional demand by Guilford for a 60-mile haul is generally more than one-third of the total revenue for hauls of 900 to 1,000 miles to Midwestern destinations.

We have suggested to Guilford that if it is not agreeable to adjusting its historic divisions, it might establish a proportional rate for the movement to Danville Junction and other gateways. Guilford's response has been totally negative. Instead, it refuses to deal reasonably with Canadian National on this efficient joint route and insists that International Paper move all Midwestern traffic via Guilford's inefficient, long haul route to Buffalo. We are thus faced with a dilemma. We can either deal with Guilford and "attempt" to obtain competitive rates via their system routes which will in any event mean totally unacceptable service for our company, or we can hope that Canadian National will provide us with a competitive rate in the face of Guilford's holding CN up for an unconscionable division of revenue.

The superior interline service route with Canadian National is essential to keep International Paper's Maine mill competitive in Midwest markets. Our attempts to negotiate directly with Guilford have been totally futile. Guilford's strategy, in our opinion, is simple and clear—to drive Canadian National from the market. In one recent effort, Guilford advised our office that all cars would have to be routed via Guilford's routes over Buffalo because of an alleged car shortage. This demonstrates how far railroads will go in harassing and attempting to drive railroads with more efficient routings from the market.

We have despaired of any negotiated remedy and have reluctantly concluded that the only option available to us is to have the Commission prescribe trackage rights for Canadian National to reach our plant under its authority to impose protective conditions on the Guilford merger. Maine paper traffic represents 40 percent of the gross revenue of Canadian National's Grand Trunk Eastern lines. Canadian National has indicated that if it is precluded from handling Maine paper traffic, it will be forced to abandon this line, thereby eliminating rail-to-rail competition via this efficient joint route.

This is just one example of the kind of problems encountered by the members of our committee. Moreover, given the ICC's policy of awarding competitive access only for proven cases of anticompetitive abuse, it is extremely doubtful that an attempt by International Paper to have a competitive joint rate and route prescribed by the Commission under the Ex Parte 445 (Sub-No. 1) competitive access regulations would be successful, particularly since the traffic involved moves in boxcars which the ICC has exempted from regulation.

VI. ICC RAIL CONSOLIDATION DECISIONS HAVE CREATED INCENTIVES FOR MERGED RAILROADS TO ELIMINATE RAIL-TO-RAIL COMPETITION

At the same time the ICC has refused to promote competitive access, it has presided over an unprecedented consolidation of the rail industry. Today, eighty-five percent of the industry's operating revenues are controlled by seven railroads. And these mergers and consolidations are continuing. A petition to reopen the Santa Fe Southern Pacific merger is pending before the ICC as is the Union Pacific's acquisition of its regional competitor, the Missouri-Kansas-Texas Railroad. There are many who believe that by 1995 there will be no more than three or four transcontinental railroads which will dominate the nation's commerce. Meanwhile, while the ICC continues to find all railroads to be "revenue inadequate", these same railroads are busily acquiring large trucking companies, barge carriers and ocean shipping lines.

Most importantly, the mergers create strong incentives on the part of railroads to use their newly consolidated market power to further restrict competition through the cancellation of joint rates with connecting carriers, the termination of reciprocal switching services or the monopolistic pricing of those services. Concentration of railroad economic power through mergers and refusals to deal fairly with connecting carriers is rampant. It is already very late in the game. This situation cries out for the prompt enactment of at least modest changes to the Staggers Act directing the ICC to affirmatively implement reasonable competitive access measures if the nation is to avoid future rail reregulation or an AT&T style rail industry restructuring.

VII. THE RAILROADS DO NOT WANT TO COMPETE WITH EACH OTHER FOR RAIL-DEPENDENT TRAFFIC

In an increasingly consolidated railroad industry, the elimination of efficient rail competition dramatically expands the ability of large railroads to use differential pricing to get increased revenues from both rail-dependent captive shippers and connecting carriers. It is important to note that the fundamental objection raised by the AAR to the PCRSC's competitive access proposals is that they would create increased competition among railroads, limiting opportunities for differential pricing and thereby impeding the attainment of revenue adequacy by the larger railroads. The record of the AAR and the large railroads is absolutely clear on this point. They simply do not want to compete with each other for captive or rail-dependent traffic. They are fighting to preserve current ICC regulatory policies which have given them this freedom from competition.

Certainly, in 1980, when Congress passed the Staggers Rail Act, it did not intend to create a system under which the railroads could increase their market share in competitive transportation markets while using differential pricing to extract rates from rail-dependent and captive shippers to maintain excess rail capacity and support inefficient rail operations. Yet, that is precisely the direction that the railroad industry, with the complicity of the ICC, has taken—all at the expense of the American shipping and consuming public.

It is the firm conviction of the Procompetitive Rail Steering Committee that only by extending competitive forces to all segments of the rail transportations market can shippers realize the full benefit of the efficiencies and cost-reducing incentives which have made the deregulation of other transportation modes successful.

VIII. SECTION 9 OF THE CONSUMER RAIL EQUITY ACT OF 1987 DIRECTS THE ICC TO AFFIRMATIVELY PROMOTE RAIL-TO-RAIL COMPETITION

The provisions of Section 9, *Enhancement of Competition*, contained in the Consumer Rail Equity Act of 1987 are intended to make it absolutely clear that all shippers are entitled to competitive rail service. PCRSC has no objection to the railroads' use of differential pricing to meet competition, but we strongly believe that differential pricing should be governed by competitive market forces and not the arbitrary decisions of a railroad oligopoly. The basic railroad-shipper compromise as embodied in the Staggers Act was that shippers would obtain increased rail-to-rail competition in exchange for freeing the railroads from rate regulation. Indeed, the concept of rail deregulation presupposes the existence of competitive transportation markets.

The joint rate provisions of Section 9 accomplishes these objectives by using a revenue-to-variable cost (R/VC) ratio comparison as a competitive pricing surrogate. R/VC ratios are widely used throughout the Interstate Commerce Act (See 49 U.S.C. §§ 10705(a), 10709) and are an accepted means of expressing the revenue contribution of a rail rate to fixed cost and profit earned by a railroad for a particular traffic movement. This revenue contribution factor is expressed as a percentage of the variable cost of transporting that traffic. The comparison of revenue and cost information on competing routes for a particular commodity thus provides a reasonable indication of the efficiency and competitiveness of two alternative routes.

In order to divert traffic to preferred routings, the large railroads cancel joint rates with connecting carriers, leaving higher combination rates applicable to the cancelled route. If the cancelled route is less efficient (i.e., higher cost) than the cancelling carrier's preferred route, the cancellation may result in the traffic moving over a more efficient route. However, if the cancelling carrier is merely attempting to maximize long haul revenues by eliminating competitive routings without regard to individual routing efficiencies, the cancellation will often result in the elimination of efficient, low-cost routes. It is precisely these types of cancellations which have created the mischief of which PCRSC is complaining and which have been found by the courts to be illegal and contrary to the public interest.

Joint rate cancellations arise in two contexts for rail-dependent shippers. The first involves preserving a joint rate with a cancelling carrier where the cancelling carrier also has an alternative competing route that yields greater gross revenues. The second involves the establishment or reestablishment of joint rate relationships. The Consumer Rail Equity Act requires a rail carrier to participate in at least one competitive joint rail rate via an actual or practical interchange connection with another railroad so as to provide the shipper with an alternative competitive route. The rate for the competing route is conclusively deemed competitive if the R/VC ratio realized by the revenue shares of the competitive joint rate is no higher than the R/VC ratio realized by the cancelling railroad on its preferred routing.

The R/VC test creates a market-driven limitation on the ability of a railroad to price its portion of the joint route in such a way as to make it noncompetitive with its own preferred routing. The use of the R/VC formula also causes the relative efficiency or inefficiency of each carrier's portion of the joint route to be reflected in the price which each carrier charges for its portion of the through service.

The reciprocal switching and terminal trackage right provisions of Section 9(b) are simple and direct. As demonstrated by *Midtec*, the ICC has not used its discretionary authority to grant shippers reciprocal switching or trackage rights. To correct this situation, Section 9(b) creates an affirmative obligation on the ICC to grant these forms of competitive access where the ICC finds it "to be practicable and necessary for the provision of alternative competitive rail service . . . or otherwise in the public interest." This provision continues to give the Commission limited jurisdiction to determine when a shipper's proposal meets the statutory criteria, but once having met those criteria, the ICC may not refuse to grant access. Most importantly, a shipper need not prove that its serving railroad acted in an anticompetitive manner before access can be granted.

IX. OTHER PROVISIONS OF THE CONSUMER RAIL EQUITY ACT PROVIDE A NECESSARY REGULATORY SAFETY NET

Let me also touch briefly on the other provisions contained in the Consumer Rail Equity Act. The railroad industry and its allies have recoiled in horror and have issued foreboding doomsday statements on the future of the industry if forced to live under the Consumer Rail Equity Act.

Fortunately, it does not take much to see through this exercise in rhetorical overkill. From the perspective of the Procompetitive Rail Steering Committee, we view the other provisions of the Consumer Rail Equity Act as a safety net. Given adequate levels of rail-to-rail competition, rail-dependent and captive shippers would have competitive routing options for both price and service. We would be able to negotiate rates and contracts with the railroad industry in arm's length transactions from positions of relative economic equality.

However, in those rare situations where market forces might not adequately discipline rail pricing practices, there is a legitimate and justified basis for residual regulatory oversight and responsibility. We believe that the Consumer Rail Equity Act provides, in large measure, a balanced and reasonable approach towards implementing that residual regulatory scheme, which will support and supplement competitive rail transportation markets.

I should add that the revenue adequacy and rate reasonableness provisions of the Consumer Rail Equity Act are potentially very significant to the members of our Committee. The Interstate Commerce Commission is currently considering the application of its coal rate guidelines to non-coal commodities in a rulemaking proceeding (Ex Parte No. 347 (Sub-No. 2), *Rate Guidelines—Non—Coal Proceedings*). The Commission has proposed to apply the same constrained market pricing/stand-alone cost tests to other captive and rail-dependent commodities which it currently applies in coal cases.

The Commission's proposal in Ex Parte 347 (Sub-No. 2) illustrates most graphically the absurdity of current ICC policy. Under the Commission's stand-alone cost test, a shipper contesting the reasonableness of a railroad rate for captive traffic must undertake litigation in which it has the burden of proving that a hypothetical alternative railroad would not charge as much for moving its freight as the railroad actually handling the shipper's traffic. This approach to maximum rate regulation makes absolutely no sense when the ICC could create actual rail-to-rail competition by granting connecting carriers competitive joint rates with the market dominant railroad. Instead of relying on hypothetical competition, the ICC could simply let competitive market forces dictate reasonable rail rates. Both the ICC and the AAR have resisted this common sense approach to maximum rate reasonableness because they are well aware that effective rail-to-rail competition will achieve far lower rate levels than the railroads would be awarded by the ICC in a maximum rate reasonableness case.

The ICC's regulatory approach to rate reasonableness totally subverts Congressional policy as embodied in the Staggers Act, which directs the ICC to rely on competitive market forces to establish reasonable rail rates. In sum, it is the position of PCRSC that most of the problems cited by captive shippers concerning the ICC's administration of maximum rate reasonableness issues could be easily resolved if the ICC were only willing to affirmatively promote increased rail-to-rail competition.

X. THE RAILROADS HAVE GROSSLY EXAGGERATED THE CONSEQUENCES OF ENACTING THE CONSUMER RAIL EQUITY ACT

In recent testimony before the House Subcommittee on Transportation, Tourism and Hazardous Materials of the Committee on Energy and Commerce, railroad representatives and their supporters have characterized the consequences of enacting the Consumer Rail Equity Act in apocalyptic terms. It is claimed that the act will cause massive reductions in rail service, greatly increase the cost of rail service to captive shippers, and bankrupt the railroad industry.

While the railroad representatives find nothing in the CURE bill to their liking, they are particularly hostile to the competitive access provisions of the bill. One rail witness claimed, "These provisions would force a rail carrier to turn over its facilities to its competitors at a price imposed by the regulator under a formula which takes no account for the owning line's loss of revenues. No other American industry labors under such a requirement." [4] Another rail witness claimed that, "Mandatory, proportional or joint rates, reciprocal switching and joint use of terminals would drive rates to unreasonably low levels." [5] The testimony of these railroad executives confirms that the railroads clearly do not want more competition for captive shipper traffic.

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[4] Testimony of Mr. John Snow, President and CEO, CSX Transportation, before the House Subcommittee on Transportation, Tourism and Hazardous Materials of the Committee on Energy and Commerce, June 3, 1987.

These executives conveniently overlook the fact that, unlike most businesses, entry barriers into the railroad transportation market are prohibitively high. Moreover, in no other transportation mode is access to service controlled through private ownership of rights-of-way. Thus, despite deregulation, railroads still retain unique market characteristics which justify remedial measures not necessary in other transportation modes or industrial markets.

We have also heard a number of parties assert that amendment of the Staggers Act will result in the loss of competitive benefits obtained from railroad deregulation. These parties claim that the Staggers Act is inviolate and that any attempt to change it will result in detrimental deregulation. These charges, of course, are preposterous. In the first place, the Staggers Act has already been amended to provide increased disclosure of discriminatory grain transportation contracts. In this respect, it should be emphasized that the CURE legislation proposes no further changes to the contract rate provisions of the Staggers Act. Moreover, 80 percent to 85 percent of rail traffic is subject to effective competition. Nothing in the Consumer Rail Equity Act will subject that traffic to reregulation. Despite blatant attempts to obfuscate the issues, the fact remains that the CURE bill is designed to extend competitive rail service to shippers who currently do not benefit from it.

The railroad industry has argued that increased competitive access will cause drastic reductions in rail revenues, force the railroads to cut back service, defer maintenance, raise prices, and recreate the conditions which produced the massive railroad bankruptcies of the 1960s. However, these rail industry projections are exaggerated and, to say the least, self-serving. They focus only on revenue reductions and fail to account for the striking progress which railroads have made in reducing costs and improving efficiency. Moreover, the railroads say nothing about the increase in traffic and market share which will result from more competitive rate structures.

The statistics of the AAR are quite interesting. Despite a reduction of almost 10 percent in track ownership from 1980 to 1985, the AAR states that a further elimination of 30,000 miles (about 19 percent of the rail network) could be accomplished with a loss of less than 4 percent in car loadings.[6] A 28 percent reduction in trackage (or 45,000 miles) would jeopardize less than 9 percent of car loadings.[7] Thus, there appears to be substantial excess capacity (and costs) within the industry which suggest additional divestitures to lower cost, more efficient regional railroads. As witnesses for the regional rail groups have testified, such transactions benefit the railroads by eliminating costs while preserving and, in many cases, increasing traffic levels for major trunk line systems.

The railroads are also responding to intermodal competition by acquiring motor carriers and barge lines. Where multimodal companies can successfully integrate various modes in a manner that realizes the flexibility and efficiencies of each mode for the benefit of shippers, without limiting market competition, such trends are healthy and should be encouraged by government policies that place railroads on the same footing as other transportation modes.

Another gross distortion by the railroads must be laid to rest. The Consumer Rail Equity Act does not put a rate cap of 180 percent of revenue to variable costs on captive shipper rates. One need only read the provisions of the Consumer Rail Equity Act to see that the Act shifts the burden of proof to the railroads, where it belongs, for rate increases in excess of the ICC's jurisdictional threshold. Under the proposed bill, if a rate increase is challenged by a shipper, the current law with respect to suspensions of increased rates will not change, and the increase goes into effect pending a determination by the ICC of the reasonableness of the rate increase. This does not repeal the economic principles of the Staggers Act, nor does it restrict the ability of railroads to differentially price their services. It merely places on the railroads the obligation to justify price increases in those situations in which there is not adequate market competition. There is nothing inherently unfair or unreasonable about placing the burden of proof on the party which has proposed the rate increase and which has access to the economic and marketing data used to justify that increase in the first place.

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[5] Testimony of Mr. Drew Lewis, President, Union Pacific Corporation, before the House Subcommittee on Transportation, Tourism and Hazardous Materials of the Committee on Energy and Commerce, June 3, 1987.

[6] *America's Railroads After Staggers: An Economic Prospectus* p. 31. Statement presented by the Association of American Railroads, before the House Subcommittee on Transportation, Tourism and Hazardous Materials of the Committee on Energy and Commerce, June 3, 1987.

[7] Id. at p. 49.

Finally, in addition to promulgating scare stories about drastic revenue reductions, the railroads have attempted to block the Consumer Rail Equity Act reforms, and especially the competitive access provisions, by interjecting rail labor problems into the Congressional debate. Railroad witnesses have testified at length concerning the issues of railroad retirement, unemployment compensation, secondary boycotts under the Railway Labor Act, and other railway labor issues. These are important matters and deserve careful consideration by the railroad industry, rail labor, and the Congress.

However, they go far beyond the limited issue of the ICC's treatment of capitive shippers under the Staggers Act. The only feasible approach is to deal with one problem at a time. If the Congress attempts to combine captive shipper issues with this miscellany of rail labor problems, the legislative/political process will stagnate, and no progress will be made on any of the problems. While a political stalemate over these issues may be in the short-term interests of the railroad industry, in the long run the financial vitality of the railroads will erode, the interests of the captive shippers will continue to suffer and the public interest certainly will not be served.

XI. CONCLUSION

Since the passage of the Staggers Rail Act in 1980, we have watched with growing concern as an increasingly consolidated rail industry has moved to eliminate rail-to-rail competition and restrict competitive options for rail-dependent shippers. Today, as a result of the ICC's failure to properly administer the Staggers Act and its own competitive access regulations, the deck is stacked in favor of the railroads and against rail-dependent and captive shippers. As long as the railroads possess this regulatory advantage, the shipping public will not be able to realize the full benefits of the competitive rail transportation market place promised by the Staggers Act.

A fundamental readjustment in the ICC's implementation of competitive access transportation policy is necessary. It is imperative that there be a strong Congressional mandate to the ICC directing it to affirmatively promote and enhance competitive access within the railroad industry as a means of ensuring that competition, not rate regulation, will effectively govern the level of transportation charges for all shippers. The Consumer Rail Equity Act of 1987 provides that Congressional directive, and we urge the members of this Subcommittee to support this legislation.

Thank you, Mr. Chairman, for the opportunity to present these views on behalf of the Procompetitive Rail Steering Committee.

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS

Question 1. The Committee Against Revising Staggers (CARS) has testified that the CURE bill will force the railroads to attempt to seek recovery of their total fixed costs by raising rates on competitive movements. Please respond to this.

Answer. The railroads may very well "attempt" to raise their rates. However, if traffic is truly competitive, the market price will determine the level of rates. It is the view of PCRSC that the extention of competitive rail service to captive shippers, rather than increasing rates, will provide a very beneficial incentive to railroads to reduce total fixed costs and operate more efficiently in order to preserve and enhance revenue and profits.

For a more detailed answer to this question, we direct your attention to our response to Senator Danforth's Question No. 1 on pages 2–3 above.

Question 2. In reviewing S. 676, the ICC has taken the position that Section 9 (the "competitive access" section) of the bill would ensure that virtually 100 percent of the rail base is reregulated in the access area and that this is without any regard to the existence of effective competition, which exists in the majority of cases. Please address this.

Answer. Given the ICC's overt hostility to competitive access, it is hardly surprising that the ICC would engage in this type of rhetorical overkill. As indicated above, shippers with viable and economic competitive choices will have no reason to invoke the competitive access provisions of Section 9 of the Consumer Rail Equity Act.

The ICC's characterization of Section 9 as "reregulation" is totally inaccurate and misleading. The purpose of this legislation is to assure that the ICC will take affirmative action to protect and promote rail-to-rail competition which the ICC has refused to do under existing law. Furthermore, as discussed above, there are sufficient limitations and standards in the statutory language of Section 9 to avoid problems with truly competitive traffic and to promote effective private negotiation and resolution of the vast majority of competitive access situations.

Question 3. How do you characterize the differences between the views of the Procompetitive Rail Steering Committee and the National Industrial Transportation League on the issue of competitive access? Where do you find common ground?

Answer. Both PCRSC and the NIT League share the view that the ICC has totally failed to adequately implement the provisions of the Staggers Rail Act of 1980 designed to protect and promote competitive access within the railroad industry. Both organizations agree that legislation is needed to remedy this failure and that the remedial legislation should address three principal areas of competitive access: joint rates and routes, reciprocal switching, and terminal trackage rights. Our differences involve primarily questions of how best to implement improved competitive access in these areas and the extent to which the Congress should expand the scope of competitive access beyond the provisions contained in the Staggers Rail Act of 1980.

In general, the NIT League legislative proposal released on July 14 would significantly extend beyond terminal areas the availability of trackage rights and the area in which reciprocal switching would be provided. The NIT League joint rate proposal also calls for broader availability of joint rate alternatives and is patterned on the "competitive line rate" proposals currently under consideration by the Canadian Pariliament.

PCRSC believes that the balance struck by Congress in the Staggers Rail Act between the railroads' needs for adequate revenues and the shippers' requirements for competitive access remains valid today. In our view, it is the ICC's failure to properly implement Congressional procompetitive policies under the Staggers Act which has created the current requirement for new legislation. Accordingly, PCRSC's legislative proposal is considerably more limited than that advanced by the NIT League and is intended to clarify and, if you will, "fine tune" the existing competitive access provisions of the Staggers Act.

Another major difference in the positions of PCRSC and the NIT League is the latter's unwillingness to embrace other provisions contained in the Consumer Rail Equity Act of 1987. We attribute this NIT League position to the fact that a number of its influential members are also active participants in the CARS group. These shippers are unduly concerned that the other reforms contained in the Consumer Rail Equity Act will in some way limit the railroads' pricing flexibility.

PCRSC supports the other provisions of the Consumer Rail Equity Act and views those provisions merely as a "safety net". If the competitive access provisions of the Act are enacted and are properly implemented, there will be adequate levels of rail-to-rail competition and rail-dependent and captive shippers would have competitive routing options for both price and service. Presumably, such shippers should be able to negotiate rates and contracts with the railroad industry at arm's length from positions of relative economic equality.

However, in those rare situations where market forces might not adequately discipline rail pricing practices, there is a legitimate and justified basis for residual regulatory oversight and responsibility. PCRSC believes that the Consumer Rail Equity Act provides a balanced, moderate and reasonable approach to implementing that residual regulatory scheme which will support and supplement competitive rail transportation markets.

QUESTIONS OF SENATOR DANFORTH AND THE ANSWERS

Question 1. Section 9(a) of the CURE bill would require the establishment of a joint rate for every traffic movement at a prescribed level.

(a) Does this, in effect, require railroads to carry traffic at rates which do not reflect the actual costs associated with the route, and which may, in some instances, even require transportation at a loss?

(b) Is this a return to the pre-Staggers era of rate equalization and open routing, which sapped the financial resources of many carriers, particularly Conrail?

(c) Under a system of differential pricing, will a reduction in coal transportation rates inevitably result in an increase in the rates of other shippers?

Answer. The premise of this inquiry is seriously flawed. Section 9(a) of the Consumer Rail Equity Act does not require "the establishment of a joint rate for every traffic movement at a prescribed level." This interpretation indicates a fundamental misunderstanding of how the provisions of Section 9(a) operate.

First, a party would have no need for implementation of this provision if the shipper and railroad agree on the rate for the particular rail service involved. Moreover, Section 9(a) does not "prescribe" rates for any particular level, rather it adopts a revenue-to-variable cost ratio test (i.e., a generic measure of revenue contribution in excess of variable cost), as a standard for evaluating the competitiveness of two alternative rail routes. These route comparisons are origin-destination specific which preclude broad application to "every traffic movement."

The purpose of Section 9(a) is to create a statutory remedy with an ascertainable standard that will enable both shippers and carriers to evaluate the economic facts of a particular transportation movement and to negotiate at arms length from equal bargaining positions. This equality of bargaining position is achieved by providing for ICC review of those situations where railroads refuse to deal with a connecting railroad or fail to participate in a realistic rate or division that will move traffic over a competing joint line route.

The use of a revenue-variable cost ratio provides a specific standard by which to evaluate joint rate and route proposals. With this standard, disputes will be limited to factual issues pertaining to the cost characteristics of particular routes, rather than subjective "public interest" policy assessments. A specific standard encourages the settlement of disputes on a bilateral, negotiated basis and discourages repeated appeals to the regulatory process merely for the purpose of establishing what the standards in each case should be.

One of the primary benefits of the revenue/variable cost test is that it avoids an arbitrary of static standard that might force a railroad into below cost pricing. Since the provision is origin-destination specific, it looks at the cost characteristics of the two competing routes and compares the contribution ratios for each route. Dr. Tye's article contains a detailed discussion of how this ratio comparison operates.[1]

The revenue/variable cost standard is specifically designed to reflect the actual costs associated with particular routes and would not require transportation by a railroad at a loss. The only way a loss could arise on a competing joint rate is if a railroad has quoted a single line rate which is less than its cost of providing such service. This obviously would be an economically irrational pricing decision. In any event, the railroad would have complete freedom to increase the rate on its single line service in order to cover its costs and whatever additional contribution it believed it could obtain from that traffic based on existing market competition.

The provisions of Section 9(a) also avoid the undesirable return to rate equalization and open routing. Under pre-Staggers Act routing, railroads participated in hundreds of routes between a particular origin and destination. Section 9(a) requires only that a railroad participate in one alternative joint or proportional rate between a particular origin and destination. Moreover, the use of the revenue/variable cost ratio standard will assure that a shipper or connecting railroad will seek the most efficient alternative joint line route over which to establish the competitive joint or proportional rate.

The revenue/variable cost test should not be confused with "rate equalization" as it was practiced by the railroad rate bureaus prior to the Staggers Act. Nor should it be compared to the "DT&I conditions", which precluded a merged carrier from unilaterally eliminating joint line routes and rates with its connections after the merger. Under Section 9(a), the carrier with the bottleneck facility[2] is free to price its single line or preferred long haul, joint rate at whatever level it determines competition will permit. At the same time the carrier which is subjected to the bottleneck is free to price its service based on its costs and existing competition and the carrier's perception of what is required to meet the single-line rate of the bottleneck carrier. Thus, the revenue/variable cost standard places no constraints on either carriers' pricing and service strategy. Each can unilaterally offer allowances or improved service to the shippers to encourage a diversion of traffic to its preferred routing without the concurrence of the other.

Indeed, the inconsistency of arguments raised by the railroads against Section 9(a) can be seen in the fact that the primary concern expressed by Mr. William Dempsey, the President of the Association of American Railroads, and other railroad executives in testimony before the Congress earlier this year was not that Section 9(a) would equalize rates, but that it would reduce rates, thereby allegedly impairing the ability of railroads to become revenue adequate. The contention by the railroads that the revenue/variable cost test results in equalized rates is illogical and directly contradicts the railroads' primary fear that Section 9(a) will result in increased competition and reduced revenues on captive traffic.

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[1] William B. Tye, "Pricing Rail Competitive Access in the Transition of Deregulation with the Revenue/Variable Cost Test", The Antitrust Bulletin, Vol. XXXII, No. 1 (Spring, 1987), pp. 119-131.

[2] Id. at p. 103, et seq.

As explained above, Section 9(a) of the Consumer Rail Equity Act does not infringe in any way on the railroad's ability to use differential pricing for various segments of its traffic base. Moreover, the concern expressed by CARS and other opposition groups that Section 9 will cause a reduction in captive traffic rates and inevitably result in increases in rates to other shippers is wholly unsupported by the facts. In testimony before the House Subcommittee on Transportation, Tourism and Hazardous Materials in May of this year, Mr. Dempsey and certain railroad executives testified that the railroads would not be able to increase rates on competitive traffic without jeopardizing this business and risking its diversion to other competing transportation modes.

PCRSC firmly believes that by extending competitive transportation options to captive shippers through Section 9 of the Consumer Rail Equity Act, the railroads will no longer be able to charge captive shippers with the costs of their inefficiency and excess system capacity. Instead, railroads will be strongly motivated to improve efficiency, reduce costs, and eliminate excess capacity in order to improve profitability, rather than simply passing their costs on to captive shippers. Most importantly, the discipline of competition in intensifying railroad efforts to reduce costs and to become more efficient and competitive should increase the demand for rail service and improve long-term rail revenues and profitability.

Question 2. Section 9(b)(1) requires the use of terminal facilities in essence on request. What impact will this have on the carriers' capital investment? Will service deteriorate as a result? Does this section create an "economic fiction" by ignoring the presence of truck competition in determining access? Do you contend that truck competition, which effectively constrains rates, is not present in many of these markets?

Answer. It is incorrect to state that Section 9(b)(1) requires the use of terminal facilities "in essence on request." Rather, Section 9(b)(1) merely modifies the provisions of existing law (49 U.S.C. § 11103) by limiting ICC discretion in granting terminal trackage rights. It would require the ICC to grant such trackage rights where the petitioner meets its burden of proving that such trackage rights are "practicable and necessary for the provision of alternative competitive rail service or otherwise in the public interest, without substantially impairing the ability of the rail carrier owning the facilities or entitled to use the facilities to handle its own business." Most significantly, the provision would be invoked only if parties cannot reach agreement.

Limiting ICC discretion to grant terminal trackage rights should eliminate debate over whether or not such trackage rights should be granted and reduced such disputes to factual issues, involving operational feasibility, the necessity for competitive service, and the extent of impairment of the owning carrier's existing operations. These are ascertainable standards which the parties should be able to apply for themselves based on the facts and circumstances involved in any particular terminal area. As a result, it is far more likely that the parties will be motivated to reach amicable agreement on terminal access because there will be no incentive to go before the ICC in an effort to avoid terminal trackage rights based solely on the ICC discretionary authority.

Since Section 9(b)(1) does not impose use of terminal facilities "in essence on request", the provision will not have a significant impact on the owning carrier's capital investment. Moreover, in the event that the owning and using railroads are unable to agree on an appropriate level of compensation for these trackage rights, Section 9(b)(1) requires the Commission to promptly establish conditions and compensation for the use of facilities. The compensation is not to exceed the costs incurred by the owning carrier making its facilities available for use by the other carrier (including both variable costs and an allocated share of fixed costs and a reasonable return associated with the facilities actually being used by the other railroad).

Once again, this language provides an ascertainable standard which the parties will be able to apply to the facts of any particular trackage situation. This will enable the parties in many instances to reach an agreement on compensation without regulatory intervention. However, if the parties are unable to agree on compensation, the statutory standard is sufficiently specific to restrict ICC discretion and to focus the regulatory investigation on factual issues which can be determined with a reasonable degree of certainty. Given these procedural and compensation standards, PCRSC does not believe that any service deterioration in terminal areas should result.

Nor does PCRSC believe that this section creates "an economic fiction" by ignoring the presence of truck competition in determining access. Where there is true competition from motor carriers, shippers would have little incentive to use this provision. However, in many situations where trucks do not provide adequate transportation options, the availability of relief through terminal trackage rights under Section 9(b)(1) will motivate railroads to voluntarily agree to reasonable access arrangements.

Question 3. where the parties in the *Midtec* case—the Soo Line and Midtec itself—simply seeking to secure lower rates? Did trucks account for nearely 40% of Midtec's traffic? Did Soo already enjoy access in the form of joint rates—and all it was seeking increased access at a lower cost? Given these factors, was the *Midtec* decision wrong in its conclusion?

Answer. Preliminarily, it should be emphasized that PCRSC was not a party in the *Midtec* case. Our participation before the ICC was as an amicus curiae. Thus, PCRSC's familiarity with the case is based primarily on the ICC and court decisions.

It is our view that Midtec was not seeking lower rates, it was seeking competitive rates and competitive service which would assist it in reaching national markets and permit it to compete against other paper companies which were benefiting from truly competitive rail service.

A careful review of the Commission's decision of December 2, 1986 indicates that in reviewing the case under the new competitive access regulations, the Commission changed the applicable evidentiary standards and gave the parties virtually no meaningful opportunity to submit additional evidence responsive to these new standards. Moreover, besides these glaring procedural defects, the majority Commissioners used the *Midtec* case as an opportunity to construe its new competitive access regulations in a manner which limits relief to those situations in which a complainant is able to establish an anticompetitive abuse. This ruling went far beyond the factual issues in the case and ignored the fundamental procompetitive purpose of the AAR/NITL agreement upon which the ICC's competitive access regulations are based.

Moreover, even applying the ICC's onerous competitive abuse standard, it is clear that there was adequate evidence of record to establish Midtec's need for competitive rail service. While trucks accounted for nearly 40% of Midtec's traffic, that does not mean that truck competition was an effective restraint on rail rates across all commodities received or shipped by Midtec. As the appendix to the Commission's December 2 opinion indicates, Midtec was totally dependent on rail transportation service for the movement of inbound commodities such as wood pulp, clay, cornstarch, limestone and fuel oil. Outbound shipments of paper moved by motor carrier only to population centers in the north central states and by rail to all other nationwide points.

Indeed, if one reads the dissenting opinions of Commissioners Simmons and Lamboley and compares them to the majority decision, one is struck by the fact that it appears that the dissenters and the majority are dealing with two different evidentiary records. It is clear that the majority Commissioners did not objectively evaluate the record and ignored or discounted important evidence submitted by Midtec and Soo Line supporting competitive access. Significantly, Commissioners Simmons and Lamboley specifically addressed this lack of fundamental fairness.

In sum, the majority opinion in *Midtec* imposed an evidentiary standard on petitioners which was far in excess of that required under § 11103 to establish entitlement to terminal trackage rights and reciprocal switching. The Commission's requirements went far beyond the relief requested by the railroads and imposed a standard of proof that is even more onerous than that which existed prior to the enactment of the Staggers Act.

The Commission then compounded its errors of law by cynically ignoring substantial portions of the evidence to find that Midtec had failed to shoulder this new burden of proof. For all of these reasons, PCRSC views *Midtec* as a legal travesty and a demonstration of the ICC's inability or unwillingness to deal with legitimate competitive access problems.

Question. 4. The ICC says that there was no clear evidence of monopoly abuse in the *Midtec* case. Under the NITL/AAR agreement, some type of abuse is required before relief can be granted. In your view, what was the specific abuse that justifies the remedy sought?

Answer. While the ICC majority decision may have concluded that there was no clear evidence of monopoly abuse in the *Midtec* case, that conclusion is not necessarily the correct one. The dissenting opinions assert that the majority ignored substantial evidence of record which indicated that Midtec received inadequate rail service and non-competitive rail rates until it filed with the ICC a complaint against CNW.

Furthermore, PCRSC does not believe that the NITL/AAR agreement requires "some type of abuse" before relief may be granted. In this regard, it should be noted that PCRSC did not support the NITL/AAR agreement and was not a party to the negotiations which led to that proposal. In any event, the ICC's requirement as embodied in the *Midtec* decision that a complainant must prove some form of competitive abuse, is a far heavier burden than was ever intended by the parties to the NITL/AAR agreement. Such a position is totally at odds with Congressional policy under 49 U.S.C. § 11103. Certainly, Congress did not contemplate that shipppers would have the burden of pleading and proving the essentials necessary to prove an antitrust case in order to obtain reciprocal switching or terminal trackage rights relief.

Turning to the facts in the *Midtec* case, the specific abuse that required relief was the failure of the CNW to provide responsive rail service and competitive rates to Midtec which the latter required in order to compete with other paper companies that benefited from competitive rail service. Until Midtec filed its complaint, CNW was unresponsive to Midtec's need for improved service and competitive rates. Based on the ICC's findings of fact in *Midtec,* PCRSC is firmly convinced that the abuses established by *Midtec* fully justified the granting of terminal trackage rights and/or reciprocal swtiching relief.

It should be emphasized that *Midtec* is not the sole justification for legislative relief. That case merely illustrates the extent to which a captive shipper must go in order to get the attention of its serving railroad. It also demonstrates the manipulative and cynical efforts of a majority of ICC commissioners determined to avoid any precedent granting competitive access. Certainly, Congress never intended that captive shippers should have to file complaints and litigate cases for years in order to obtain responsive service and competitive rates from the railroads.

Senator EXON. Thank you very much.

Mr. Lind.

Mr. LIND. Chairman Exon and members of the Subcommittee, good morning. My name is John W. Lind. I am the Director of Corporate Transportation and Distribution for Corning Glass Works in Corning, New York and serve as Vice President of The National Industrial Transportation League.

Accompanying me today is John F. Donelan of Donelan, Cleary, Wood & Maser, who is the League's general counsel.

We appreciate that our full written statement is being made part of the Committee's hearing record.

With respect to the ICC stewardship of the Staggers Rail Act, while the Act appears to be working well for the majority of rail shippers, we still have concern about the need to foster effective competition throughout all segments of the industry.

With respect to S. 676, the League does not believe that enactment of this legislation will serve the needs of our membership for a variety of reasons involving both its rate equity and competitive access provisions.

If there is one common theme uniting shippers on the Staggers Rail Act, it is a belief that the ICC should place greater emphasis on competitive access. Competitive access goes to the root of the problems faced by the rail captive shippers. Rail-to-rail competition provides an alternative to the regulatory arena which forces shippers and carriers to assume adversarial roles and to rely on Washington for the solutions to their problems.

This concern about competitive access is best exemplified by the action taken by our membership at its 1986 annual meeting which directed the League to pursue legislative efforts in the 100th Congress to foster increased intermodal competition, including competitive access.

Since this action last November and in accordance with the spirit of the ICC's invitation in Ex Parte No. 456, the League has been trying to foster competitive access by using all available forms, including the Commission, the courts, and open dialogues with railroad industry representatives. In fact, the League is developing its own competitive access proposal to meet the requirements of this mandate.

We believe that enactment of a single issue bill dealing solely with competitive access will best serve our members' needs. This proposal is based on three basic concepts: reciprocal switching; competitive line rates; and, trackage rights and use of needed ancillary facilities. The League believes that this approach will be more far reaching than what is provided for in section 9 of S. 676.

Our proposal involves procedures and mechanisms calling for a maximum reliance on marketplace forces and a minimum of ICC involvement in its administration. The details of this plan will be provided to the committee as soon as we finalize it.

In summary, the League's proposal could automatically provide reciprocal switching in certain designated areas where large volumes of traffic are generated without the necessity of an ICC proceeding on the merits of any individual case. Additionally, it would allow any carrier to establish a competitive line rate to reach any shipper or receiver who believes the proposed service to be of benefit. This, of course, would be subject to the owning carrier receiving adequate compensation.

The League would limit the ICC's role in these two areas to compensation disputes. Our plan on trackage rights would eliminate the need for costly regulatory and court proceedings which may result in implementing the concept of reasonable distance contained in section 9 of S. 676. This proposal attempts to make available any line segment needed to promote direct rail-to-rail competition.

We thank you for this opportunity to present the views of the shipping community. We look forward to working with you and your staff to accomplish our mutual goal of a more market-disciplined rail industry. We would be glad to answer any questions you might have.

[The statement and questions and answers follow:]

STATEMENT ON BEHALF OF THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

Chairman Exon, Members of the subcommittee: Good Morning, my name is John W. Lind. I am director of Corporate Transportation and Distribution for the Corning Class Works, Corning, New York, and serve as vice president of the National Industrial Transportation League. Accompanying me today is John F. Donelan of Donelan, Clearly, Wood and Maser, who is the League's general counsel.

The League is a voluntary organization of shippers, shippers' associations, boards of trade, chambers of commerce, and other entities concerned with the purchasing of freight transportation services. It is the only nationwide organization representing shippers of all sizes and commodities using all modes of transportation to move their goods in intrastate, interstate, and international commerce. Its members, directly or indirectly, are responsibile for the routing of about 80 percent of the nation's commerical freight.

The League is pleased to be here this morning to present its views on the Interstate Commerce Commission's stewardship of the Stagger Rail Act, and on S. 676, Consumer Rail Equity Act of 1987.

As we have testified at previous oversight hearings, the League believes that the provisions of the Staggers Act provide a workable balance between the goals of assuring the rail industry's revenue adequacy and of maintaining and fostering effective competition within the industry.

When competition, especially rail-to-rail competition, exists, the Act appears to be working well. In these instances, it has justified Congress's faith in the ability of the marketplace to effectively regulate transportation services. However, where this competition is absent, our members continue to be concerned about the Commission's stewardship of this law.

It is difficult for the League to make a more detailed assessment about the Commission's stewardship of the Act, since there is no single decision to analyze and give a passing or failing grade. Understanding the agency's handling of the Act requires a familiarity with the numerous decisions it has issued affecting the critical issues of adequate funding for the industry and adequate redress for captive shippers.

Quite frankly, although the Commission has made progress in correcting its earlier decisions which placed too much emphasis on assuring rail revenue adequacy, these corrections have not always fully met shipper needs. In addition, there are still critical decisions to be made. One of the major decisions yet to be rendered is the application of rate guidelines to non-coal commodities. However, we are grateful for the improvements which have been made.

To better understand how the League views the agency's handling of the Act, furnished below are our comments on the proceedings we believe critical to assessing the ICC's success in balancing shipper and carrier needs.

Ex Parte No. 290 (Sub-No. 2), Railroad Cost Recovery Procedures—The Commission has modified these procedures so that when the Rail Cost Adjustment Factor declines from the previous quarter, this decline can be recognized and reflected in future revenue needs. Previously, there was no mechanism to account for decreases in the RCAF. In its decision, the ICC created a bank of credits to be applied against future increases in the RCAF, rather than order that refunds be made to affected shippers or order that current rate levels be reduced. The League supported the agency's action. However, it had urged that decreases be reflected immediately in the RCAF tariffs, and refunds be made to the affected shippers.

Ex Part No. 320 (Sub-No. 3), Product and Geographic Competition—The League supported the reforms adopted by the Commission which eased the burdens placed on shippers in dealing with this portion of the market dominance test. Since the adoption of these rules, the agency has begun to find that market dominance exists. The recent remand by the U.S. Court of Appeals for the District of Columbia Circuit in the Green River soda ash case should serve as a good "bell weather" in assessing the impact of these new rules. The court overturned the agency because of its use of the geographic competition standards in effect prior to the changes made by this accord.

Ex Parte No. 347 (Sub-No. 1), Coal Rate Guidelines—Nationwide—These rules on establishing levels of maximum reasonableness for coal freight rates are a critical element in assuring the success of the Act. The League has supported, opposed, and suggested changes to various portions of these requirements. While not perfect, they have improved as they evolved. The League would note that the U.S. Court of Appeals for the Third Circuit has upheld the most recent standards, finding them consistent with the 4-R and Staggers Rail Acts.

Ex Parte No. 347 (Sub-No. 2), Rate Guidelines—Non-Coal Proceedings—This is one of the key missing elements in determining the success of the Staggers Act. at present, the ICC is soliciting comments on two different alternatives for determining maximum reasonable rates for these commodities. This case also is expected to include provisions which would make it easier for small shippers to exercise their review rights before the agency. The League currently is formulating its position on the two alternatives. In earlier comments, the League urged the agency to adopt procedures which would allow shippers and carriers to informally present their cases to administrative law judges and then negotiate a voluntary settlement, which, if reached, would be subject to ICC approval. It also has opposed applying the Ex Parte No. 347 coal rate guidelines to other commodities.

Ex Parte No. 387, Railroad Transportation Contracts——While the Conrail Privatization Act required additional disclosure of contract information for certain agricultural commodities, the ICC has proposed to extend these requirements to all commodities. The League supports the proposal to the extent it is limited to the commodities described in the law and to the extent it reflects the private sector agreement reached by the Association of American Railroads and the National Grain and Feed Association. However, it is strongly opposed to applying these new requirements to other commodities. One of the Act's most successful features has been contracting authority. The League is deeply concerned that if these rules are adopted as proposed, the benefits which have accrued to shippers and carriers alike will be seriously eroded. It may well create problems for those captive shippers who have chosen this method of service to meet their unique transportation needs.

Ex Parte No. 389, Procedures for Requesting Rail Variable Cost and Revenue Determinations for Joint Rate Surcharges and Cancellations—The Commission recently adopted as final the interim rules it proposed in 1981. In doing so, it partially included the League's request that circuity factors not be automatically included in developing this data. However, it denied the League's requests that actual weights, not minimum tariff weights, be used in these calculations, and that the burden for cost information be placed solely on the carriers.

Ex Parte No. 393 (Sub-No. 1), Standards for Rail Revenue Adequacy—Earlier this year, the Commission revised these standards incorporating most of the suggestions made by the shipping community. However, the agency declined to include two changes—use of the embedded cost of debt and use of multiple financial factors rather than just the cost of capital. The League had urged the agency to use the multiple factor approach.

Ex Parte No. 445 (Sub-No. 1), Intramodal Rail Competition—The League is very proud of its role in negotiating this accord with the Association of American Railroads and the Chemical Manufacturers Association, and securing its adoption by the Commission. The League believes that it has proved useful in helping shippers to solve their problems with carriers without resorting to lengthy and costly administrative remedies. This has occurred because the accord requires voluntary negotiations prior to seeking regulatory relief. For your information, Appendix A of our testimony is a document which more fully explains how the 45-1 accord works when applied to marketplace problems. This Leauge circular, which was supplied to the membership, answers the 20 most frequently asked questions about the accord. We are equally pleased to report that the U.S. Court of Appeals for the District of Columbia Circuit recently upheld these rules and denied challenges by utility and railroad interests.

While far from perfect, the accord presents a sound framework for resolving a variety of the competitive access problems faced by shippers. The League believes that the solution to more perfectly balancing shipper and carrier needs lies in strengthening competitive access mechanisms within the railroad industry. This issue will be addressed later in our testimony.

In assessing the Commission's record in handling this accord, we admit that it is a mixed bag of results. Critics of the accord will point to the agency's rulings denying access rights in the *Midtec* and *Arizona Public Service Company* cases.

However, since its adoption, the agency is using the accord to consider relief in other cases and to prevent joint rate and route cancellations. Specifically, these cases are: Docket No. 38676, *Changes in Routing Provisions—Conrail—July 1981;* Docket No. 40118, *Vitsa Chemical Company* v. *Atchison, Topeka & Santa Fe Railway Company;* I & S Docket No. 9268, *Cancellation of Joint Route on Transit at Gonzales, TX, SP;* I & S Docket No. 9266, *Cancellation of Joint Routes at Bureau, IL, IIRR;* and I & S Docket No. 9267, *Cancellation of Single-Factor Through Rates in Coal, CNW.*

Ex Parte No. 462, Exemption of Demurrage Charges from Regulation—The Commission has proposed to deregulate demurrage charges—the fees paid by shippers when cars are held at their facilties after the time specified in a tariff. The League has opposed the plan, saying that neither total or partial deregulation of these services is warranted at this time. The ICC has yet to issue a decision, and is still reviewing the comments it solicited early last year.

Ex Parte No. 464, Railroad Cost of Capital—1985—This proceeding is the first cost of capital finding to be made under the ICC's revised revenue adequacy standards in Ex Parte No. 393 (Sub-No. 1). The cost of capital finding of 13.6 percent is an improvement over the 1984 finding of 15.8 percent. However, none of the nation's two dozen Class I railroads met this earnings standard. In issuing the decision, two of the commissioners criticized the agency for being a year later in making these findings. Another criticized it for using a methodology "which even the majority admits may be flawed." The League agrees with both these criticisms.

Ex Parte No. 465, Railroad Revenue Adequacy—1985 Determination—This proceeding is the first revenue adequacy determination to be made under the ICC's revised revenue adequacy standards in Ex Parte No. 393 (Sub-No. 1). For the fourth consecutive year, none of the nation's 24 Class I railroads were found to be revenue adequate, despite the fact that Wall Street and other financial analysts have been favorably impressed by the financial performance of some of these carriers. In issuing the decision, two of the commissioners dissented from the majority ruling. The League agrees that the cost of capital methodology must be further improved to give a better indication of the industry's fiscal health.

Ex Parte No. 466, Railroad Cost of Capital—1986—The Commission currently is seeking comments on determining last year's cost of capital for the industry. The League believes that the deficiencies noted above will be perpetuated unless remedial action is taken.

Ex Parte No. 466 (Sub-No. 1), Railroad Cost of Capital—Proposed Expedited Procedure—The League is pleased that the Commission is seeking to improve its procedures for cost of capital determinations. In early comments on this issue, we urged the agency to begin these proceedings earlier in the year, and to ensure that adequate public comment is allowed. We hope that our suggestions will be heeded.

Railroad Accounting Principles Board's Exposure Draft—While the exposure draft is still pending with the RAPB, it ultimately will be up to the Commission to implement their recommendations. Since the board is expected to complete its work shortly, this issue will be before the agency sometime this year. Like the Ex Parte No. 347 (Sub-No. 2) case, this piece of the puzzle will have a significant impact in assessing the success or failure of the ICC's stewardship of the Act. In its comments to the board, the League expressed its overall satisfaction with the exposure draft and the board's proposed railroad accounting principles, although it did urge that certain other proposed principles be modified in whole or in part.

In the almost seven years since the law's enactment, the League has seen its members place an increasing emphasis on competitive access issues. During the early stages of the Act's implementation, our primary focus was rate equity matters, such as market dominance, rate reasonableness, and revenue adequacy.

While these issues are still of concern, recent ICC actions appear to be restoring the balances contemplated by Congress. Thus, the policy debates within the League have focused on the need to provide the shipping community with choices in selecting transportation price and service packages, especially with respect to promoting competition within the railroad industry through the fostering of joint rates and routes, reciprocal switching, and trackage rights.

In 1985, the League, in cooperation with the Association of American Railroads and the Chemical Manufacturers Association, negotiated the private sector accord which resulted in the competitive access guidelines adopted by the ICC in Ex Parte No. 445 (Sub-No. 1). At our 1986 Annual Meeting, the membership increased its emphasis on competitive access by adopting the following resolution: "The Board [of Directors] approves the past actions taken by the League with respect to competitive access, but, in the future, the League should pursue legislative efforts in the 100th Congress to foster increased intramodal competition, including competitive access."

Since this action last November and in accordance with the spirit of the ICC's invitation in Ex Parte No. 456, *The Staggers Railroad Act of 1980—Conference of Interested Parties,* the League has been trying to foster competitive access by using all available forums including the Commission, the courts, and open dialogues with railroad industry representatives. In fact, the League is developing its own competitive access proposal to meet the requirements of this mandate.

With respect to S. 676, the League does not believe that enactment of this legislation will serve the needs of its membership for a variety of reasons involving both its rate equity and competitive access provisions.

With respect to the rate equity issues affecting the Commission's use of its discretionary review powers, League policy calls for the greatest possible reliance on marketplace forces to set transportation rates. Based on these policies, as well as the positions it has taken in the applicable agency proceedings, it would note the following concerns:

In section 3, which amends market dominance standards, the League believes that the ICC's recent administrative reforms corrects past inequities.

In section 4, which affects rate reasonableness standards, the League believes that these changes will return the industry to the strict regulatory regime of the 1970s and earlier—a regime which did not serve the present or future needs of either shippers or carriers. To enact them into law will have serious adverse repercussions for a large segment of the rail shipping community.

In section 5, which affects amendments to the National Rail Transportation Policy, the League is deeply concerned that the addition of subsection (15) will increase greatly the complexity of any rate or related cases brought before the agency. In essence, it asks that the Commission engage in decisionmaking based on international market conditions. This is a job for which it has neither the necessary expertise or resources.

The League would not object to the changes proposed in subsection (6). However, we see the wording change to be of little benefit, since whether or not it is stated in this subsection, the financial health of the industry will, for all practical matters, remain a consideration in setting policy.

In section 6, which affects inflation-based rate increases, the League would not object to that portion codifying the ICC's recent decision requiring that this mechanism account for productivity gains. Assuming that the decision will withstand pending court challenges, this action appears to be unnecessary. However, we are deeply concerned that the additional changes made in this subsection will unduly delay and complicate the current process, and could result in lengthy litigation which serves neither the needs of shippers or carriers.

In section 7, which affects revenue adequacy standards and procedures, the League supports the Commission's recent actions in this area, and sees no need to take further legislative action. Whatever problems may exist with these standards and procedures, we believe that they are more effectively solved on an administrative basis.

In section 8, which affects the agency's exemption authority, the League does not believe that these amendments would serve its members' best interests. We see these changes as posing a serious threat to the status of past exemptions, which appear to be working well, and to the future of the short-line and regional railroad industry. These carriers are an important part of the national railroad transportation system. Their ability to take lines which are marginal to the major carriers and make them into profitable operations has preserved and enhanced service to many shippers, especially those located in less populated areas. We fear that the changes contained in this subsection could be used to inhibit their formation.

In section 9, which affects competitive access, the League believes that proposed changes do not adequately address our members' need for promoting competition within the industry to the maximum extent possible. As noted earlier, the League is progressing its own competitive access proposal which we believe more effectively meets the membership mandate we received at last year's Annual Meeting.

This proposal is based on three basic concepts—reciprocal switching, competitive line rates, and trackage rights and use of the needed ancillary facilities. Since the proposal is under review and subject to revision, I cannot share its exact details. However, it does involve procedures and mechanisms calling for a maximum reliance on marketplace forces, and a minimum of Commission involvement in their administration. This plan will be provided to the subcommittee as soon as it is finalized.

The League believes that this approach we contemplate is more positive than what is provided for in this bill. The League proposal would automatically provide reciprocal switching in certain designated areas aimed at reaching large traffic-generating areas of the country without the necessity of an ICC proceeding on the merits of any individual case. The agency would be used only to resolve compensation controversies.

With respect to competitive line rates, the League proposal would allow any carrier to establish a rate to reach any shipper or receiver who believes that the service would be of benefit, subject to the owning carrier receiving adequate compensation. Like reciprocal switching, the ICC's role would be limited to compensation disputes. Unlike section 9, this plan is not restricted to single competitive alternative, and lets the marketplace determine the viability of any proposed new service. It protects the owning carrier by providing adequate compensation, rather than enmeshing the parties in costly agency and court proceedings.

With respect to trackage rights, the League proposal attempts to reach any line segment needed to promote direct physical competition. We believe our plan would eliminate the need for costly regulatory and court proceedings needed to define section 9's concept of "reasonable distance."

In section 10, which affects abandonment procedures, the League sees no need to make any changes at this time. Based on the experience of our members, we see no problem with the current procedures.

In section 11, which affects state authority over intrastate rail matters, our members strongly support this provision of the Staggers Act, and believe it is essential to preserving the degree of jurisdictional harmony shippers currently enjoy. We fear that any changes to these requirements could result in deviations from federal standards which would impose burdensome administrative requirements on our members. We would strongly urge that no remedial action be taken in this area.

In conclusion, the League believes that the provisions of the Stagger Act provide a workable balance between the goals of assuring the rail industry's revenue adequacy and of maintaining and fostering effective competition within the industry.

Where competition, esecially rail-to-rail competition, exists, the Act appears to be working well. In these instances, it has justified Congress's faith in the ability of the marketplace to effectively regulate transportation services. However, where this competition is absent, our members continue to be concerned about the Commission's stewardship of this law.

We believe that our concerns about the ICC's stewardship of the Act can best be addressed through the fostering of effective competition so that as few shippers as possible are deprived of the benefits it has brought to the rail shipping community.

However, we do not believe that S. 676 provides the answers to our concerns or will result in a more efficient or market disciplined rail industry.

To assist in the efforts to resolve the problems of rail captive shippers, the League is progressing its own competitive access proposal. We hope to complete work on this plan within a reasonably short period of time, and will furnish its details to the subcommittee as soon as it is finalized.

We thank you for this opportunity to present the views of the shipping community. We look forward to working with you and your staff to accomplish our mutual goal of a more market-disciplined railroad industry. I and counsel would be glad to answer any questions you may have.

**THE
NATIONAL
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July 17, 1987

The Honorable Fritz Hollings
Chairman
Committee on Commerce, Science
and Transportation
United States Senate
Washington, DC 20510-6125

Dear Chairman Hollings:

In response to your letter of July 2, enclosed are the League's answers to the written questions submitted for the Surface Transportation Subcommittee's June 24 hearing on oversight of the Staggers Rail Act and the need to take further legislative action in this area.

The League appreciates this opportunity to present the views of the shipping community. If we can be of any furthe assistance, please do not hesitate to contact me.

Sincerely,

Jack Lind

John W. Lind
Vice President

COMPETITIVE ACCESS

During the initial years after enactment of the Staggers Act, responses from the League's Railroad Transportation and Legislative Committees, as well as from the membership itself, indicated a strong interest in the Interstate Commerce Commission's rulemakings on such issues as revenue adequacy, market dominance, rate reasonableness, use of its exemption authority, and the like.

However, in 1983, the League members identified a new area of concern -- assuring adequate competition among the declining number of major rail systems. The rash of mergers which followed implementation of the Act, the massive cancellation of joint rates and through routes, and the sudden growth in the captive shipper population, deeply concerned our members. They feared that these reductions in competition would thwart Congress's goal of a market disciplined railroad industry.

Since 1983, policy debates within the League continued to focus on how to increase competition among the declining number of major competitors. As one League member pointed out -- the issue is not how many railroads serve the nation; the issue is how many railroads serve my facilities.

For the last two years, our members have made competitive access their number one objective in the rail area. They believe that fostering effective competition throughout the industry is the only way shippers would be freed from the vagaries and inefficiencies of the regulatory regime so that rail transportation services can be fashioned in the most productive manner possible.

An important factor in this debate is the unique situation of railroad ownership. In the air, water, and trucking industries, rights-of-way are publicly held. As a result, competition can be stimulated through entry reforms. However, in the railroad industry, rights-of-way are privately held, so that current entry reform does very little to promote competition.

Our members believe that the only viable solution to entry reform is competition. Without it, policymakers must either nationalize the roadbeds and related facilities -- an option opposed by the League -- or must adhere to an economic regulatory solution to effectively police the carriers' use of their monopoly powers.

From our members' perspective, economic regulation is costly and defeats marketplace innovation, since no important actions can be taken without prior approval from Washington. However, if the regulatory focus is shifted to promote the use of competitive rates and routes, reciprocal switching, and trackage rights, shippers and carriers are free to structure services which best meet their needs, while preventing any single carrier from abusing its market power.

If the prediction by John Fishwick, former chairman of the Norfolk Western, comes to pass -- the nation ultimately will be served by no more than three or four major carriers, policymakers must find ways to eliminate or substantially reduce the rail captive shipper population, or resign themselves to an economic regulatory system which does not effectively serve our policy goal of improving America's ability to sell her goods both at home and abroad.

RATE REASONABLENESS

The League believes that the rate reasonableness standard proposed in section 4 of S. 676, Consumer Rail Equity Act of 1987, would be more onerous than that applied in the 1970s and earlier for a variety of reasons.

First, the railroads are made to assume all burdens of proof after a shipper makes the initial showings demonstrating that this is an issue for ICC review. Today, shippers carry these burdens. Even in the late 1970s, the Commission was beginning to more fairly allocate burdens in these proceedings. Thus, this bill makes changes exceeding current practice or what had been the practice during the waning days of pre-1980 regulation.

Second, and probably more importantly, the bill requires the application of the Long/Cannon factors in a manner which far exceeds the intent of their drafters. Thus, the bill's requirements for detailed analyses of a railroad's total pricing practices in each and every rate case is extremely onerous.

When the Long/Cannon factors were drafted in 1979, they were meant to give the Commission a better understanding of what traffic on a given railroad, if any, was moving below cost or below feasible marketing levels. During this time, reliable information on rail costing practices left much to be desired. It was only after implementation of the Staggers Act that railroad costing activities began to approach those in general business and industry.

However, CURE supporters today clearly indicate that in each and every rate proceeding, the railroad at issue would have to furnish two sorts of information. The first would be on that traffic moving below the cost of providing service. The second would be what increases could be put on all other traffic to obviate the need for additional revenues from the traffic at issue.

Since the Staggers Act prohibits a railroad from pricing below a level which contributes to going concern value, the first problem pretty much has resolved itself over the past seven years. It is this second data showing which seriously complicates rate reasonableness proceedings.

The burden on the railroads would be significant. Not only would they have to identify every instance in which traffic was moving at a revenue/cost ratio below the one being challenged, they also would have to show that these shippers were not willing to pay more for this service. In essence, the carrier would have to supply evidence that each of these shippers would divert freight from the line if their rates were raised. This burden would be enormous and often would be to no real purpose.

If this standard was to be adopted by Congress and implemented by the Commission, the time needed to process a rate case would be doubled, if not tripled. Given the unacceptable delays associated with these cases under current procedures, this is not a reform which is in the captive shipper's interest.

LEAGUE'S LEGISLATIVE PROPOSAL

The basic difference between the League's plan and that contained in section 9 of S. 676 is subtle but important. In essence, the League plan empowers shippers and carriers to structure whatever services are to their mutual economic benefit. It limits the Commission's role basically to resolving compensation disputes and other technical matters. It breaks from the traditional regulatory approach by allowing services to be market driven.

The CURE bill relies on the traditional regulatory approach -- require the agency to devise a "one size fits all" solution to these issues, and makes shippers and carriers conform their needs to these requirements.

Other important differences are the League's much more flexible use of competitive line rates, including proportional rates, and the extension of reciprocal switching to areas generating large volumes of traffic. The League's legislative proposal also provides more readily available trackage rights as a means of furnishing competitive railroad access.

Senator **Exon**. Mr. Lind, thank you very much.

The Chair recognizes Mr. Dempsey.

Mr. **Dempsey**. Mr. Chairman, I am glad to be here to present the views of the Association mainly on the CURE bill. I will adopt by reference Mr. Riley's testimony with respect to the labor protection issue, because I do not have time to go into it.

As to CURE, let me consider first what appears to be the central question, whether or not this is simply fine-tuning, or whether indeed, it is, as we believe, taking the ax to the piano.

I do not have enough time to go into all of the provisions of the act. Let me take two by way of illustration.

First, the question of the scope of the Commission's jurisdiction, what kind of cases can it consider. The Staggers Act at its heart had the principle that there should be no commission regulation where there is effective competition.

The CURE bill provides, quite to the contrary, that there shall be regulation, even if there is effective geographic and product competition.

So in that respect, it is contrary to Staggers' central principle, and it greatly extends the scope of commission regulation, because there are countless cases in the United States in which a shipper or a receiver has access to two or more railroads from different points of origin. Utilities are a clear example.

Now, having extended the scope of the Commission's jurisdiction in this very significant way, what is the Commission supposed to do when it considers rate reasonablenss issues?

The Staggers Act provided that there should be no presumption of illegality of a rate simply because it is over 180 percent ratio of revenue to variable cost, the threshold of commission jurisdiction.

This bill provides precisely the contrary. First, it shifts the burden of proof to the railroads in all cases. And then it makes the railroad under that burden prove that it needs adequate revenues—a curious notion, it seems to me, and certainly not one applied to any other industry in the United States—and then it makes the railroad prove that it needs to have rates in excess of 180 percent.

So even to the most obtuse regulator, the difference between CURE and Staggers is evident. A presumption of illegality is established with respect to rates over 180 percent, and then it gets worse.

Because it provides that the railroad must also prove the Long-Cannon factors. That means that the railroad must prove that every rate that it has is set at an optimum level, given the market.

It is obviously an impossible burden. So what we have as a practical matter is a cap of all rail rates at 180 percent revenue to variable cost.

Now, unhappily, Senator Rockefeller has left at just the point that I wanted to discuss this question with him, and I may wait to see if I have a minute left at the end, whether or not he comes back in time.

Senator **Exon**. I am sure he will be back.

Mr. **Dempsey**. I am sure, too. But he may not ask the right question, and I want to get my answer in.

Senator **Exon**. Ah, he has returned.

Senator **Rockefeller**. I want to be sure you get your fair shot.

Mr. **Dempsey**. Thank you so much, Senator.

I want to take this opportunity not only to reaffirm my testimony with respect to the impact of reducing all rail rates to 180 percent, but to underscore its importance.

Because I think that it is the single factor that demonstrates mostly clearly the baleful effects of the CURE bill.

Now what I testified was that if you reduced all rail rates to 180 percent, the railroads would lose roughly $1.5 billion in net operating revenues, which would wipe out the revenues of the industry.

Senator Rockefeller draws the inference from that that what I am really saying is that all of the profits of the industry come from the shippers transporting at rates over 180 percent.

That means, by its corollary—and that's 20 percent of our freight—that if we dropped 80 percent of our freight, we would still make $1.4 billion, and that obviously is not correct.

We have run some more figures, by way of illustration. If we kept all the rates above 180 percent, as they are, and then took the rates between 180 percent and 130 percent down to 130 percent, what do you think we would lose in net revenues? $1.5 billion.

So if one can say that the shippers above 180 are producing all profits for the industry, then one can say that all shippers between 130 and 180 are doing that, too.

The statements obviously cannot coexist, and the reason is self evident—any traffic that moves a rate above variable costs contributes to the "profits" of the rail industry in the sense that it makes a contribution to fixed costs.

Now, given all of that, what is the reason asserted for the CURE bill. What abuses have been shown?

No one brooks the delays of the Commission. They appear to be coming under control; I certainly hope they are. They are not good for the railroads anymore than they are for the shippers.

But that does not mean that you ought to have a bill that imposes more burdens on the Interstate Commerce Commission. That certainly sounds counterproductive to me.

But the rates, Mr. Riley has given you the data on that; it is in my testimony as well. There is no indication of rate abuse by the rail industry of the coal shippers or the utilities or anybody else.

Our rates have gone down in real dollar terms.

I will close with two facts that seem to me to be compelling; they may not be to anybody else, but they are to me.

In terms of the level of coal rates, they're the same as they are for other commodities. We have 20 percent of our commodities over 180 percent, on average; we have 20 percent of our coal rates above 180 percent.

So there certainly is no singling out of coal shippers by the rail industry. And if one goes in terms of revenue per ton mile, rail rates are way down.

Finally, Mr. Riley gave you the number of protests a year. Most of those obviously have been washed out by settlement or by withdrawal or whatever, because in total only 23 rate cases remain.

Of those—and I just close with this—of those, only two involve rate actions by railroads subsequent to Staggers. Only two. Neither one is a coal case.

If the assertions that have been made were correct, one would have expected a torrent of rate protests and complaints. There has scarcely been a trickle.

Thank you, Mr. Chairman.

[The statement and questions and answers follow:]

Statement of William H. Dempsey, President, Association of American Railroads

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to present the views of the Association of American Railroads on the implementation of the Staggers Act of 1980 (hereafter "Staggers") and on S. 676, a bill which would drastically revise that Act, and on S. 816, S. 1026 and S. 1040, bills which would amend the law with respect to the sale of railroad lines. As the Subcommittee knows, there are widely diverging views as to how well or how "faithfully" the Interstate Commerce Commission (hereafter "the Commission" or "ICC") has carried out its responsibilities under Staggers. The divergence in views stems, I believe, from differing perceptions of the objectives of Staggers and the actions necessary to their achievement. I would like to start, therefore, by reviewing those objectives.

I. THE BACKGROUND OF STAGGERS

As is often the case with such broad pronouncements, the statements of purpose and national policy which form the preamble to Staggers can be read to satisfy most wants. But one cannot look at the railroad crises of the 1970's—crises to which this Subcommittee had to respond in virtually every Congressional session—without concluding that one objective of Staggers was paramount. That objective was the creation and maintenance of an economically sound railroad system—one that could remain viable in the private sector.

The nation was experiencing in the 1970's the fruits of a rail regulatory system in which a decision-making process based on political rather than economic judgments had become traditional. Twenty one percent of the industry was in the hands of bankruptcy trustees and the question of nationalizing the railroad industry was being given serious consideration. By 1980, it was plain for all to see that if the railroad industry was to survive in the private sector, federal regulation had to be premised on economic reality.

The fundamental reality of an economic system founded on investment of private capital is the need for adequate returns on that capital. Disinvestment due to inadequate returns had become the hallmark of the railroad industry and the inadequacy of returns was seen as the inevitable product of an outdated regulatory system. That system, founded on the theory of monopoly regulation, was plainly unable to cope with the task of regulating railroads operating in a largely competitive environment.

To survive in a competitive environment, the railroads had to be given greater control over their assets and the freedom to adjust services and prices to demand. In short, they needed the opportunity to earn an adequate return on investment—an opportunity long denied by the regulatory system then in place. A brief review will show that in its essential terms Staggers sought to revise the regulatory structure to respond to that need:

The commission was required to consider the revenue adequacy objective in determining the reasonableness of rail rates.

Rates below a prescribed revenue-to-variable cost percentage (currently 180) were deemed to be competitive and not subject to maximum rate regulation.

Rate adjustments based on an inflation index could not be contested.

Rate increases by revenue inadequate railroads that did not exceed six (now four) percent of the base rate annually could not be suspended.

The railroads were permitted to contract with the purchasers of rail service.

The ICC's authority to exempt railroad services from regulation was broadened.

State regulation of rail rates was preempted unless conducted in conformity with federal standards.

Relief was provided from non-compensatory joint rates.

Collective ratemaking was eliminated.

II. THE COMMISSION'S IMPLEMENTATION OF STAGGERS

A. The Economic Criteria Applied.—A fair examination of the regulatory proceedings initiated to implement Staggers will show that, in the main, the Commission has been faithful to the fundamental purpose of the Act. The most contentious proceedings have been those dealing with revenue adequacy standards, market dominance standards and maximum rate standards. In each of these, the basic issue has been the selection of the proper economic criteria. While the railroads have not agreed with the Commission's decisions in all respects, those decisions have been based in each case on extensive comment by expert witnesses and an abundance of legal argument. And in each case the decision has been subjected to, and upheld upon, judicial review.

The electric utilities have been in the forefront of those arguing that the Commission erred fundamentally in its selections of economic criteria and in the last Congress—through the C.U.R.E. organization—they proposed revisions to Staggers which would have the Congress prescribe what they argued to be the correct standards. Because of the pendency of that legislation the AAR sought the views of the nation's most eminent economists as to the general validity of the economic criteria applied by the Commission in implementing Staggers. The statement endorsed by those economists was submitted to the Subcommittee last year but is attached to this statement for ready reference. (Attachment 1) It is to be noted that the list of 56 endorsers includes two Nobel Laureates in economics, two former chairmen of the President's Council of Economic Advisers, two former members of the Council, and a past president of the American Economic Association.

In addressing the three basic issues of revenue adequacy, market dominance, and maximum rates, the economists subscribed to the following principles:

1. The appropriate standard for determining the adequacy of railroad revenues is a rate of return equal to the current cost of capital on the replacement value of all rail assets that are required to meet the demands for railroad service, regardless of the source of funds used in investing in those assets.

2. In determining whether a railroad faces adequate competition in a particular market, it is appropriate for the Interstate Commerce Commission to consider all sources of competition in that market, including: competition from other carriers moving a given product between the given points of origin and destination, competition arising from consignees' ability to obtain the same product from other sources and to obtain close substitute products from any source, and shippers' ability to sell in other markets.

3. In setting "reasonable rates", which we take to mean rates that encourage the efficient use of resources not only of the railroads and their customers but also of the entire economy, the following principles should apply:

Where marginal cost pricing produces total revenues that are less than total cost, some form of pricing that reflects the responsiveness of demand to price (Ramsey-like pricing) is economically efficient and, where returns are below the market cost of capital, is essential for railroad financial viability.

Rate prescriptions based on fully allocated cost or other ratios of rate to cost are, in such circumstances, arbitrary and inefficient;

Defined as the cost a rail carrier would currently have to incur to furnish a particular service or group of services in isolation, "stand-alone" costs provide, in principle, an objective standard for setting the maximum price a railroad, whose revenues are inadequate, should be permitted to charge in markets where competition is not effective.

In summary, we believe the Staggers Rail Act of 1980 to have been a substantial step toward rationalizing transportation policy and that continued pursuit of the principles stated above would serve the interests of the public at large.

The principles espoused in the economists' statement are the principles embraced by the ICC in its rulemakings. When C.U.R.E argues that the Commission has failed to implement those provisions of the Act in a "balanced and sensible manner." [1] there should be no mistake as to the implications of the argument—it is for a rejection of economically rational regulation and a return to the political decisions of yesteryear in which the railroads were used as instruments of national policy to subsidize any interest which, at the moment, seemed worthy of subsidy. Only with that hope and expectation are the economically sound criteria adopted by the Commission not "balanced and sensible."

The inevitable consequence of the legislative effort initiated by the electric utility and coal interests in 1985 and continued in 1987 is to enmesh the Congress in the task of evaluating and prescribing regulatory guidelines. I submit that is not a proper task for the Congress unless it is prepared to undertake the extensive analyses necessary to reach an informed judgment on such highly technical matters. It is a task the Staggers Act left to the Commission and, based on the statement of experts, one the Commission has effectively performed.

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[1] Testimony of W. Reid Thompson on February 21, 1986, before the Senate Commerce, Science and Transportation Committee.

Currently, one of the most contentious issues arising out of the Commission's implementation of Staggers is that of "competitive access." C.U.R.E. is now joined in its attack on Staggers by a small group of large shippers, called the Procompetitive Rail Steering Committee (PRSC), who—under the guise of an asserted right to competitive access—seek to destroy differential pricing and the maximum ratemaking standard. I will discuss this issue more fully in my analyses of the C.U.R.E. bill and the PRSC arguments in behalf of that bill.

Two other key provisions of Staggers left for the Commission's implementation were those dealing with the contract and exemption authorities. Each of these provisions have been used extensively and have proved to be of great value both to railroads and to shippers. The Commission's effort in these two areas have, in general, been well received. C.U.R.E. stands alone in its efforts to emasculate the exemption authority.

B. The Handling of Individual Cases.—While the railroad industry is, in the main, satisfied with the regulatory guidelines adopted by the Commission, it is far from satisfied with the Commission's application of those guidelines in specific cases. In two recent decisions involving application of the coal rate guidelines, the rail rate was found unreasonable and reparations of $23.6 million in one case and $21.8 million plus interest in the other were ordered.[2] Both of these decisions are on appeal, the principal issue in each being the proper method for calculating "stand alone" cost.

In the past month, the Commission decided a case involving grain rates on grounds which we believe are wholly unsupportable.[3] In each of these cases, we are convinced that the Commission erred in applying its guidelines. Unlike the C.U.R.E. group, however, we are prepared to accept the decisions of the judiciary on whether the Commission's actions conform with the law.

The Commission has been severely criticized by some shippers for its delay in deciding cases. I will leave to the Commission the defense of its record in that regard. However, two points are worth noting. First, any lamentations by members of C.U.R.E. with respect to protracted litigation should be viewed with great skepticism given the fact that the salient features of the C.U.R.E. bill are its provisions assuring the institution and maintenance of non-stop regulatory proceedings before the Commission.

The second point to be noted in mitigation of the Commission's delay in deciding cases is the unique character of the so-called "section 229" proceedings. Section 229 of the Staggers Act gave shippers a last chance to complain about rates in effect on October 1, 1980. Rather than miss the chance, shippers responded with many complaints which, absent section 229, would probably never have been brought. Some 870 cases were filed with the Commission under that section within a sixty-month period following enactment of Staggers. Indeed, many, if not most, were filed in the final month of that period (March 1981). And these were not simple cases. Some involved hundreds of different movements. In judging the Commission's performance consideration should be given the volume and complexity of the cases at issue.

III. S. 676, THE C.U.R.E PROPOSAL AND ITS EFFECTS

C.U.R.E. and the advocates of its bill proclaim that the bill does not re-regulate the railroads but, to the contrary, only "fine tunes" the Staggers Act. To say that S. 676 only "fine tunes" Staggers is to say that strychnine only "flavors" headache compounds. Certainly, the hoped-for results of the C.U.R.E. bill as expressed by some of its supporters, would do more than "fine tune" rail revenues. Senator Rockefeller has been quoted as hoping for a $3-$5 per ton reduction in rates on West Virginia coal, while Congressman Rogers has stated that the bill's proponents expect a $6/ton saving on coal as a result of the amendments to the rate reasonableness section of Staggers. Witnesses on behalf of shipper groups have spoken of decreases in rail rates of as much as 25 percent through obtaining rail-to-rail competition, under the bill's competitive access provisions.

About 140 million tons of coal moved at rates above 180 percent of variable cost in 1984 so if the hopes of the bill's sponsors were realized the railroads would lose revenues on the order of $850 million in coal movements alone—enough to wipe out most of their net income in 1986. With railroad revenues in the order of $28 billion, the realization of anything approaching a 25 percent reduction in rates as a result of mandatory competitive access would be catastrophic.

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[2] *Omaha Public Power District* v. *Burlington Northern RR.*, No. 38783, decided November 14, 1986; *Arkansas Power and Light* v. *Burlington Northern R.R.*, Nos. 36719, et al., decided May 17, 1987.

[3] *McCarty Farms et al.* v. *Burlington Northern R.R.*, No. 37809, decided May 22, 1987.

As the following analysis shows, the C.U.R.E. bill is anything but "fine-tuning"—it is re-regulation with a vengeance.

A. The Statement of Purpose (Section 2).—According to its statement of purpose, S. 676 seeks the same goals as the 4-R and Staggers Act but "under a balanced approach that encourages and promotes intramodal competition while providing adequate protection for persons served by market dominant rail carriers." The terms of a bill, as well as its declarations, reveal its true purpose, and the terms of this proposed bill make clear that its purpose is to reinstitute detailed and comprehensive regulatory restraints on the railroad industry and to de-emphasize its needs to earn adequate revenues. If enacted, the bill would impair rather than foster the goals of Staggers.

B. The Market Dominance Amendments (Section 3).—The bill amends the existing market dominance section (49 U.S.C. 10709) to prohibit the ICC from considering product and geographic competition in determining whether "effective competition" exists. It also provides that the fact a railroad faces effective competition with respect to an origin shall not establish a presumption that the railroad faces effective competition with respect to a destination (and vice versa).

In excluding consideration of product and geographic competition in determining whether there is an absence of effective competition for rail service, the bill defies logic and verges on the nonsensical. Product and geographic competition are facts of life in the marketplace. To pretend that those forms of competition do not constrain rail rates is to deny the obvious. It is to assert that a utility which can obtain identical coal from three different sources served by three different railroads is "captive" to each road—that the interest of each road in obtaining the traffic has no influence on the rates offered. It is to assert that the price of Japanese cars has no influence on the price of domestic cars.

Until this year, the utilities argued that the shipper's obligation to prove the absence of product and geographic competition placed too much of a burden on the shipper. Now that the Commission has shifted the burden of proof to the railroads,[4] the utilities argue for the elimination of product and geographic competition on the ground that the shippers always win on that issue and raising it simply delays getting to the merits of the complaint!

A far more plausible reason for the utilities' effort to eliminate consideration of product and geographic competition is that, with its elimination, they can challenge otherwise unchallengeable rates. Thus, where two railroads deliver coal to a utility from different mine sources, there is not transportation competition but there is geographic competition. If the law were changed to preclude consideration of geographic competition, the utility could assert market dominance wherever the service by different carriers was not from a common origin and the railroad could not even introduce evidence of the competition that in fact was constraining its rate. The result would be a large increase in the ICC's regulatory jurisdiction since many shippers, of course, are served by two or more railroads, by rail/barge, or by rail/truck from different origins.

The provision precluding a finding of effective competition at an origin point from establishing a presumption of effective competition at a destination point (and vice versa) is generally consistent with the proposal developed by the AAR, the NIT League and the American Paper Institute, and which was adopted by the Commission. It is, therefore, unnecessary.

C. The Rate Reasonableness Amendments (Section 4).—Subsection (a) of section 4 of the bill places the burden of proof as to rate reasonableness on the railroad in all cases.

Subsection (b) of section 4 deletes the current statutory provision requiring the ICC to "recognize the policy of this title that rail carriers shall earn adequate revenues", (49 U.S.C. 10701a(b)(3)) and substitutes for the deleted language the requirement that in determining whether a rate (other than a recyclable rate) is reasonable the ICC shall consider and make affirmative findings regarding: the need of the railroad carrier to have the opportunity to achieve or maintain revenue adequacy; whether and to what extent such need requires allowing the rail carrier to charge rates which result in revenue/variable cost ratios in excess of the jurisdictional threshold; the relationship of the rate to the cost of service; and the Long-Cannon factors.

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[4] Pursuant to an agreement between the AAR on the one hand and the NIT League and American Paper Institute on the other.

Under existing law, the assignment of the burden of proof turns on the distinction between complaints challenging proposed new or changed rates and complaints challenging rates that are in effect. Whenever a rate charged a shipper is to be increased, or a rate for a new service is to be established, the shipper is given notice and an opportunity to protest the change and to seek its suspension and investigation. If the Commission finds market dominance and decides on the basis of the shipper's protest to suspend and/or investigate, the carrier has the burden of proving the proposed increase is reasonable.[5] If, based on the carrier's response to the protest, the Commission refuses to suspend and/or investigate, the shipper is given a second bite at the apple—it may file a complaint after the rate goes into effect. In taking the second bite, however, the shipper also assumes the burden of proof.

Under the proposed bill, a shipper could protest any proposed rate increase and if, based on the carrier's response, it failed to secure an investigation, it could file a complaint. However, instead of having to come forward with evidence as to the unreasonableness of the rate, it could sit back and require the railroad to come forward again with evidence as to the reasonableness of the rate. If the shipper was not sanguine about the prospects of effectively rebutting that evidence, it would simply withdraw its complaint. Thus, for every rate increase subject to the jurisdiction of the Commission, a shipper could put a railroad through the regulatory wringer twice simply by filing two pieces of paper—complaints before and after the rate takes effect.

A shift in the burden of proof is especially pernicious given the other provisions of section 4 which would reflect a fundamental change in legislative policy—from one of encouraging the attainment of adequate revenues to one of viewing rail rate increases above the 180 percent threshold as presumptively unwarranted. This would be the inevitable consequence of a shift in the burden of proof accompanied by an amendment deleting the requirement that the Commission, in determining the reasonableness of a rate, recognize the policy of the Act that "rail carriers shall earn adequate revenues."

Even the most obtuse regulator would conclude that the Congress was trying to put a lid on rail rates if it adopted a bill which told the regulator to stop worrying about the railroads' needs for adequate revenues and make them prove they needed any rate increases. The deletion of the directive that, in rate reasonableness cases, the Commission consider the railroad's need to achieve adequate revenues demonstrates beyond question C.U.R.E.'s utter lack of concern for fundamental economic principle and its willingness to send the railroad industry once more down the road to bankruptcy. It is axiomatic that any private business entity must earn adequate revenues (i.e., revenues sufficient to cover its costs and a reasonable return on its investment) if it is to remain in business without public subsidy. If a firm is denied that opportunity, it will be unable to raise the capital necessary to maintain its assets and to attract new capital for expansion and its exit from the market or demise as a private entity will be inevitable.

Indeed, in enacting Staggers Congress emphatically recognized that the failure of the prior regulatory regime to implement this fundamental economic principle effectively was one of the primary causes of the financial decline of the railroad industry. In again seeking to relegate the railroad industry to the vagaries of a regulatory process which does not recognize the industry's need to earn adequate revenues as its fundamental policy objective, C.U.R.E. is plainly placing the short-run financial gains of its members ahead of the maintenance of a railroad industry that is viable in the private sector.

But, the bill gets worse. Not only is the Commission not to consider the statutory policy that railroads be allowed to earn adequate revenues, to the contrary, it is directed to find whether the railroad even needs the opportunity to achieve or maintain adequate revenues. Assuming that a railroad can prove to the Commission that indeed it does need to have at least the opportunity to achieve revenue adequacy, the bill then requires a finding as to whether the railroad needs to charge any rates in excess of 180 percent of variable cost. That percentage is the current jurisdictional threshold for the exercise of maximum rate regulation by the Commission.

The requirement for an affirmative finding as to "whether and to what extent" a carrier needs to charge rates which result in revenue/variable cost ratios in excess of the jurisdictional threshold of 180 percent is an irrational and unsupportable restriction on differential pricing. It gives significance to a cost calculation relating to the jurisdictional threshold that, as the Congress explicitly provided in Staggers, should not be taken into account in determining the maximum reasonableness of a rate.[6]

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[5] The Commission may not suspend or investigate a rate increase that does not exceed 4% above the railroads' inflation index unless the rate as increased equals or exceeds 190% of variable cost.

And, again, the bill gets worse. Not only must a railroad prove that it has to charge any rate in excess of 180 percent of variable costs, it must also prove that the rate is reasonably related to the cost of service. That provision, in the context of the rest of the bill, can be argued to imply a congressional determination that cost-based pricing is to supplant demand-based pricing for any rate in excess of 180 percent of variable cost.

And, once again, the bill gets worse. To get a rate increase, a railroad must also prove—and the Commission must make "affirmative findings" with respect to—the "Long-Cannon" factors, i.e., (1) that no traffic is moving below cost, (2) that other shippers are not being charged less than they are willing to pay, and (3) that no commodity is paying an unreasonable share of the carriers' overall revenues.

In other words, a carrier must prove, and the Commission must find, that every rate in its rate structure is optimumly set. This is a burden that obviously could not be met except perhaps in a marathon proceeding the length, complexity, and cost of which would dwarf any prior proceedings in the history of the Commission. And this would be the character of every rate case. And C.U.R.E. would have the Congress believe that that is not re-regulation, but just a little "fine tuning!"

D. The Rail Transportation Policy Amendments (Section 5).—The bill would amend the rail transportation policy by: stressing the need to regulate rates where there is an absence of effective competition and eliminating the nexus between reasonable rates and revenues necessary to maintain the rail system and to attract capital; adopting a policy of encouraging and promoting "competitive transportation rates for domestically produced coal and other commodities and products in order to increase their competitive position in both domestic and export markets."

Considered in conjunction with the proposed section 4 amendment that would eliminate consideration of the Staggers Act policy that "rail carriers shall earn adequate revenues," these proposed amendments would further assure that the regulators' political judgment as to what Congress intended by the Act would turn away from any concern that railroads earn adequate revenues and tilt toward lowering the costs of shippers by lowering rail rates, especially those of coal shippers. Addition of the catch-all "other commodities and products" does not disguise the fact that the C.U.R.E. bill is, in the main, a product of the coal and utility interests and is intended to serve their interests. Shifting the policy emphasis of the law from railroad revenue needs to shipper costs is, of course, only a little more "fine-tuning."

E. *Inflation Based Rate Adjustment Amendments (Section 6).*—The bill:

Requires adjustments to the Rail Cost Adjustment Factor (RCAF) to reflect "changes in railroad productivity, volume, and output mix" retroactive to October 1, 1980.

Requires adjustments for forecast errors retroactive to October 1, 1982.

Requires rate decreases to the extent of any decreases in the RCAF.

The amendment to the cost recovery index process requiring that adjustments to the Rail Cost Adjustment Factor (RCAF) reflect "changes in railroad productivity, volume, and output mix" is unnecessary and inappropriate. The issue as to whether productivity can even be measured is a highly technical issue which is best left to an administrative agency for resolution and is currently being considered by the ICC on the merits in Ex Parte No. 290 (Sub-No. 4).

Moreover, the proposal ignores the fact that competition forces the railroads to pass on to the shipper most productivity gains. This is done through "hold-downs"—which reflect the inability, due to competition, to pass on inflationary rate increases authorized as a result of increases in the RCAF—and through contracts. The latter frequently have provisions limiting increases to less than the full index change which is, implicitly, a productivity offset. The best evidence that any productivity gains are regularly passed through to the shipper is the revenue realized per ton-mile of freight carried. In the period 1981–85, while the rail inflation index increased 6 percent, the revenue per ton-mile realized by the railroads decreased 1.3 percent.

Finally, the proposal would treat the railroad industry like no other industry in the competitive sector. Firms which achieve productivity gains through innovation or other means retain the fruits of those gains until their competitors catch up.

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[6] See section 10709(d)(4).

That is the incentive for innovation and improved efficiency, an incentive which this proposal would impair.

The proposed retroactive adjustment to the Rail Cost Adjustment Factor for forecast errors is also unnecessary. The Commission has already directed such an adjustment retroactive to the fourth quarter of 1985, which is the date it selected for rolling back rates to reflect decreases in the Rail Cost Adjustment Factor. Moreover, even if the RCAF were corrected all the way back to 1980 for forecast error, the change would only be three tenths of one percent—a change hardly worth the attention of the Congress.

The amendment requiring that rates be reduced when the RCAF declines is also unnecessary. The Commission promulgated regulations compelling such adjustments on October 17, 1986. While some aspects of that decision are on appeal, the Commission's authority to compel the roll-back of rate increases taken in the future under a special master tariff is not being challenged.

F. *Revenue Adequacy Amendments (Section 7).*—Simply stating the terms of this provision shows how preposterous is the C.U.R.E. claim to "fine tuning." Section 7 of the bill fundamentally alters the standard for determining revenue adequacy and then turns what is presently a single, reasonably simple proceeding for applying that standard into a multiplicity of complex proceedings. Specifically, it:

Deletes "economic profit" and "(or both)" from 49 U.S.C. 10704(a)(2) which contains the requirement that railroad revenue levels provide "a reasonable and economic profit or return (or both) on capital employed in the business."

Requires the Commission, in setting adequate revenue standards and in determining adequate revenue levels to provide with respect to each rail carrier: for identification of revenues, expenses and investment base reasonably related to providing rail transportation service; for including in the investment base of each carrier only those assets reasonably related to providing rail transportation service valued at original cost depreciated less deferred taxes; for excluding from the asset base any costs previously charged off as an operating expense; and for determining the cost of capital using the "actual cost" of debt capital and "reasonable estimates" of the current cost of equity to each carrier, "taking into consideration all relevant financial information, including but not limited to bond ratings, fixed charged coverage, return on shareholders' equity and debt to equity ratios (including the reasonableness thereof)."

The bill further provides that, in making its annual determinations of revenue adequacy for each carrier, the Commission "inquire into and consider" the Long-Cannon factors; determine the revenues required by each carrier after making any "appropriate" adjustments due to Long-Cannon factors; require each carrier to submit the information necessary to the above determinations; and provide the public an opportunity to comment on that information and on the revenue adequacy of each carrier.

1. Amending "Economic Profit or Return".—The statutory requirement that an adequate revenue level for railroads include "a reasonable and economic profit or return (or both) on capital employed in the business" originated with the 4-R Act. The legislative history of that Act sheds no clear light on Congressional intent in employing the term. Economists use the term "economic profit" to refer to profits in excess of costs including returns to shareholders. The Congress would not intend that railroads generally be allowed excessive profits. It would be fair to infer, however, an intention to allow railroads like all other competitive industries to earn above normal profits (returns) in some years to compensate for years in which inadequate profits (returns) were realized. Such averaging would be necessary if the railroads were to earn adequate returns over the long run. The deletion of the phrase "economic profit" could be construed as an intentional action to prohibit such averaging.

The word "economic" modifies the word "return" as well as the word "profit". An "economic return" means, to an economist, a return equal to the current cost of capital—and that is the standard the ICC has adopted.[7]

Upon deleting the words "and economic profit", the law would provide only for "a reasonable return". This change gives effect to the other amendments in this section of the bill (discussed below) which, in the aggregate, would preclude the railroads from every earning the current cost of capital and which would, therefore, be a prescription for disinvestment in the railroad industry.

2. Amending the Revenue Adequacy Standards and Procedures.—Under current law and procedure the determination of revenue adequacy has two elements. The first is the prescription by the Commission of a general standard of industry-wide applicability. That has now been determined to be a return on investment equal to the current cost of capital. After years of fighting against the cost of capital standard—albeit the one the utilities insist be applied to themselves—C.U.R.E. now acknowledges that it is essentially correct. Its efforts have now been turned to attempting to emasculate the standard by attacking the calculation of the cost of capital and of the investment base against which the return is to be measured. In short, its objective now is to attempt to lower the allowable return by casting in legislative concrete highly technical aspects of the cost of capital calculation, some of which have already been rejected in proceedings before the Commission as being economically unsound.

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[7] See the first principle adopted in the Economist's Statement supra, p. 4.

The amendments limiting the investment base to original cost less depreciation, excluding previously charged off costs from the rate base, and requiring the use of the "actual" (presumably meaning "embedded") cost of debt and "reasonable estimates" of the current cost of equity in determining the cost of capital deal with issues that have all been through the regulatory process at least twice. The decision to use the current rather than embedded cost of debt was first found correct in 1981 in Ex Part No. 393 and upheld on appeal, and found to be correct again in 1986 in Ex Parte No. 393 (Sub-No. 1) which is now on appeal.

Whether to use the original cost (depreciated) or replacement cost of assets in determining the investment base was an issue also considered in Ex Parte No. 393 (Sub-No. 1). In that proceeding, the railroads argued that assets should be valued at their replacement cost. The Commission rejected that argument and reaffirmed the use of original cost (depreciated). So this C.U.R.E. provision amounts to nothing more than an attempt tc legislate a debatable accounting matter on which it has already twice prevailed before the Commission.

In its most recent decision, the Commission has also determined that deferred taxes—another debatable accounting issue—should be excluded from the rate base so legislation on that point is unnecessary.

3. The Issue With Respect To Excluding Previously Charged Off Costs From the Asset Base.—The proposal to exclude from the investment base any costs previously charged off as an operating expense is simply one more of C.U.R.E.'s unceasing efforts to make the Congress the arbiter of arcane accounting controversies which have already been dealt with appropriately in administrative proceedings.

Since the dawn of railroading, track structures have been subjected to the "retirment-replacement-betterment accounting" (RRB) procedure. RRB accounting was adopted on the theory that track was a unique asset in that, as long as periodic maintenance was adequate, track life on the whole (i.e., viewed on a system-wide basis) could be extended indefinitely.[8] Under RRB, as under depreciation accounting, the initial track installation cost is included in the asset base. However, the initial installation cost is not written down (i.e., reduced in amount) as it is under depreciation accounting but is "frozen" in the asset base at original cost. As a track replacement of similar quality occurs (e.g., replacing 110 pound rail with 110 pound rail), the cost is recorded as a maintenance expense in the year incurred. Where a track replacement consists of a "betterment" (i.e., an improvement in the quality of the track component, such as substituting 132 pound rail for 110 pound rail) the incremental cost of the betterment (the difference between the cost of 132 pound rail and current cost of 110 pound rail) is added to the asset base) while the remainder of the replacement cost is expensed. Should a line be abandoned, the original investment and the betterment (net of salvage value) are written out of the property account, at their original cost, as expenses. Salvage is treated as an asset. In theory, where railroads perform annual pro rata track replacements and price levels remain relatively constant, RRB would yield approximately the same results as would be achieved by straight-line depreciation.

In its decision of December 31, 1986 in Ex Parte No. 393 (Sub-No. 1), the Commission adopted depreciation accounting (DA) for track structures in lieu of RRB—an action supported by the various shipper groups. In converting from RRB to DA it was necessary to restate the value of the track assets. The railroads were directed to do this by taking the value of the last replacement of each piece of track and depreciating it from the replacement date—the method prescribed by "generally accepted accounting principles" (GAAP) which are promulgated by the Financial Accounting

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[8] It is this concept that distinguishes RRB accounting from depreciation accounting which is employed for all other railroad assets and by businesses generally. Under depreciation accounting, an asset is deemed to have a finite life. It is added to a firm's investment base when acquired and its cost less its expected salvage value is then prorated over the assumed life of the asset as a depreciation expense.

Standards Board. The result is that the track accounts today reflect exactly the same value as they would if they had always been under the DA system. The restatement has no adverse impact on present or future rail shippers.

Shippers such as C.U.R.E. argued that this restatement procedure results in a "double recovery" because any "replacement" component of the last track installation would already have been recorded as an expense. The Commission rejected the argument on several grounds:

(1) "[I]n real economic terms, the first charge taken—the 'replacement' charge under RRB—simply represents the economic cost of the former track (which had never previously been 'written off'), while the subsequent depreciation charges represent the 'write-off', over time, of the actual cost of the track currently in place."

(2) In many cases, there isn't even nominally a "double recovery"; it would depend upon the remaining "life" of the track at the conversion date.

(3) The double recovery argument assumes that the railroads in fact recovered the expense of their track. To do so, they would have had to earn their cost of capital for the period in which expenses were taken under RRB. In fact, they fell far short of earning their cost of captial over that period.

(4) Adjusting for the alleged double recovery would systematically misstate the expenses relating to the investment in the track in place and being used today to provide freight service.

The C.U.R.E. argument also conveniently ignores the fact that the current value of the railroads' track accounts was severely understated under RRB accounting, and that even with restatement of the railroads' track accounts, depreciation accounting substantially lowers the railroads' total depreciation and maintenance expenses. Thus, there is no double recovery in the conversion from RRB to DA, there is only less understatement of the current value of the railroads' rate base, accompanied by a diminution of the railroads' ability to expense the current cost of repair and replacement of their track assets.

4. The Issue With Respect to Using The Embedded Versus Current Cost of Debt.— The utilities argue that the cost of capital (the weighted average cost of debt and equity capital) should be determined by using the "embedded" cost rather than the "current" cost of debt. The "embedded" cost is the average cost of debt already on the books. The "current" cost is the cost of new borrowings. C.U.R.E. argues for the use of embedded debt because that is what state regulators use in regulating electric utilities. The fact that the use of embedded cost by state regulators of utilities might work for utilities does not mean it is right for railroads.

The practice of measuring required returns on debt on the basis of embedded debt costs is economically unsound and works in utility regulation only because the utilities are monopolies. But railraods are not monopolies and the use of the embedded cost of debt would deny them the opportunity to earn an adequate return. This fact becomes clear when viewed from the perspective of any investor.

If current debt costs increase over embedded interest levels, the value of a firm's debt decreases and the value of its equity increases. If debt costs fall below embedded levels, the opposite will occur. For this reason, investors in competitive markets must consider current debt costs in determining the firm's true capital costs and the value of the firm's expected returns in relation to the return opportunities presented by other investments. Regulatory cost of capital determinations based on a standard which has nothing to do with current market values will eventually lead to misallocations of capital because consumption, production and investment choices by consumers, the firm and its investors would be unrelated to economic costs.

Use of the embedded cost of debt by state regulators in determining a utility's cost of capital does not deny the utility adequate average returns over the long run only because the utility has sufficient monopoly power to set rates at levels which will always cover the costs of embedded debt, regardless of current debt costs. Consequently, although the practice of state regulatory agencies is economically unsound, it does not penalize utility investors.

In regulating the railroads, the Commission cannot afford to ignore these economic realities. If it were to limit the railroads' return opportunities by using the embedded cost of debt in measuring their cost of capital, it would constrain them to levels of earnings below those available in competitive markets when current debt costs exceeded embedded debt costs; and when current debt costs fell below embedded debt costs, the market would hold railroad earnings to a level which reflected the current costs. Thus, if embedded debt costs were used in measuring the cost of capital, railroads would in effect be forced at all times to earn rates of return reflecting the lesser of the embedded or the current cost of debt. They would be precluded in the long run from the opportunity to earn, on average, a competitive, cost of capital return. On the other hand, use of a market rate for debt will assure railroads no greater earnings opportunity in the long run than the embedded rate standard will allow monopoly utilities.

5. The Issue With Respect to the Cost of Equity.—It is not clear what, if anything, is to be read into the proposal that the return on investment for railroads be determined using "reasonable" estimates of the current cost of equity (taking into consideration "all relevant financial information"). The Commission has prescribed an accepted methodology for determining the current cost of equity. The application of that methodology is scrutinized each year by the parties to the cost of capital proceeding. The drafters may be hoping to use the qualifying term "reasonable estimates" as a prop for a later argument that the Commission must discount the cost of equity as determined by the methodology now in place whenever necessary to balance the interests of the utilities, i.e., whenever the use of the "actual" cost of capital would warrant revenue levels (and hence rate levels) which the utilities thought too high.[9] With such ambiguous language, C.U.R.E. may be attempting to follow a less obvious path to the same objective—a means of finding railroads to be revenue adequate even though they are earning returns on investment far below the current cost of capital.

6. The Issue With Respect to the Long/Cannon Factors.—The proposal to require consideration of, and specific findings with resepct to, the Long/Cannon factors in determining revenue adequacy is entirely consistent with the objective manifested throughout the bill of resubmerging the railroads in the regulatory sea without life support systems. A study prepared for the Commission by A.T. Kearney Associates some years ago found that only about 10-15 percent of railroad traffic could be considered captive.[10] Instead of having the ICC focus its energies on the rates to be charged that 10-15 percent, the bill would divert the inquiry to how the other 85-90 percent of the traffic is being priced. Such an inquiry necessarily requires the regulator to dissect every facet of rail operations (costs) and the marketing of rail services (rates) to determine and then pass judgment upon how attentive rail management is to the maximization of profits.[11]

Regulation is usually invoked to rein in the excesses of self-interest, not to spur its pursuit. The ICC considered and rejected a rulemaking proposal which would have injected it into the heart of railroad management via the Long/Cannon provision. In doing so, it presumed that, as profit-seeking organizations, railroads generally would strive to price in a profit-maximizing manner. It said, however, that it would consider the Long/Cannon factors in specific rate cases where the shipper involved had a direct interest and some basis for questioning a railroad's rate-setting practices. That is a reasonable application of the Long/Cannon provision. It would be wholly unreasonable to require such an inquiry in a general revenue adequacy determination because that inquiry would necessarily rest on a presumption that railroad management often does not strive to price services at profit-maximizing levels.

To engage in such across-the-board inquiries as to railroad pricing practices, the ICC could not avoid immersion in the management decision process. For evidence as to consequences of that kind of regulatory intervention, one need only look back to the mid-70's and the gross inefficiencies attending ICC's intrusion into the railroad management process through its car service orders—e.g., requiring that unit trains be broken up to increase the supply of single cars. By its proposal to inject the Long/Cannon factors into the revenue adequacy determination, C.U.R.E. plainly displays more interest in the creation of a regulatory maze than in the creation of an efficient national railroad system.

Such an outcome is assured by C.U.R.E.'s proposed amendment requiring each railroad to submit evidence on all of the above factors and providing an opportunity for public comment thereon. What is now a reasonably simple determination based upon calculations of the cost of capital would be converted to an annual non-stop regulatory proceeding. In such a proceeding, the only real winners would be the lawyers participating. The real losers would be the rail shippers and electricity consumers who ultimately pay legal fees and the railroads who must divert their managerial talent from doing their jobs to explaining how they are doing them.

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[9] The utilities do not, of course, expect anything other than the current cost of equity from their own regulators. This fact is borne out by the list of rate filings appearing in the January 8, 1987 edition of Public Utilities Fortnightly. The rate increases being sought by 24 electric utilities yielded returns on equity ranging from 13.75 to 19 percent. The return on equity of the railroad industry in 1985 was 6.83 percent.

[10] That study is reinforced by the most recent waybill data which indicates that about 80% of rail traffic moves at rates below the regulatory jurisdictional threshold—a figure which does not take account of the fact that much traffic above that level is constrained by rail, truck, product and geographic competition.

[11] In addition to this annual inquiry, section 4 of the bill would, as noted earlier, also require such an inquiry in each rate proceeding.

G. The Exemptive Authority Amendments (Section 8).—The bill would:

By changing "shall" to "may", make permissive the existing mandatory requirement that an exemption be granted upon certain findings;

Require "other persons" as well as shippers to be considered by the ICC in determining whether continued regulation is necessary to protect against abuses of market power;

Prohibit exemption of any transportation as to which a rail carrier has market dominance; and

Make exempt rates and practices subject to all other Federal statutes, and not subject to the regulation, supervision or other jurisdiction of the Commission.

The Staggers Act represents a Congressional commitment to deregulation. It, therefore, commanded that the Commission "shall" exempt from regulation any service as to which it finds that regulation is not necessary to carry out the transportation policy of the Act and that the service is either of limited scope or that regulation of the service is not needed to protect shippers from the abuse of market power. Changing the command "shall exempt" to "may exempt" represents a retreat from that commitment.

This retreat is turned into a rout by the provision permitting exemptions only for transportation over which the rail carrier does not have market dominance. Such an amendment effectively nullifies the exemption provision. Inherent in the existing standard—abuse of market power—is the understanding that the absence of market power is not a pre-condition to an exemption. To the contrary, what the Commission must find is the absence of a likelihood that any market power that exists will be abused.

Literally hundreds of "markets" exist for every commodity transported by rail. In deciding whether to exempt a commodity from regulation the Commission considers market conditions generally. It could not practically examine the competitive conditions in each market. Consequently, the Commission grants exemptions on the theory of exceptions. The matter being considered for exemption having been determined to be generally free of the likelihood of abuse of market power, the grant is conditioned on the express intention to deal with any specific complaints of abuse as they may arise.

The C.U.R.E. approach would turn this process on its head and require an examination of every conceivable movement under the proposed exemption upon the single objection of an "interested person." The consequence of having to produce such mountains of evidence would effectively deter railroads from seeking, and the Commission from approving, any exemptions other than those of very limited scope.

The exemption authority would be even further impaired by the prohibition elsewhere in the bill against considering geographic or product competition. Not only would the issue of market dominance have to be considered with respect to every conceivable movement, but the hurdle the railroads would have to clear to show the existence of competition would be raised. As a practical matter, none of the major exemptions granted to date, such as fresh fruits and vegetables or TOFC/COFC, would be issued under the proposed amendments.

The amendment making exempt rates and practices subject to all other Federal statutes is intended, presumably, to assure the applicability of the antitrust laws to exempt traffic. The bill goes further, however, and arguably revives all state common law remedies applicable to common carriers by rail. This would put the railroads in the position vis-a-vis state law that they were in prior to enactment of the Interstate Commerce Act in 1887. All of the common carrier obligations that were intended to be eliminated by the exemption would be reinstated. In effect, an exemption would remove the railroads from a comprehensive (and at least cohesive) set of Federal regulations but subject them to a far worse regime—the vagaries of the common law of every state.

Nullifying the exemption authority in the Staggers Act is, of course, just a little more "fine tuning."

H. The Enhancement of Competition Amendments (Section (9).—Subsection (a) of section 9 amends section 10705 of title 49, U.S. Code to require a rail carrier on request of another carrier having an interchange with that carrier between the origin and destination of any movement, or upon request of a shipper or receiver, to establish at least one competitive joint rate (or competitive proportional rate) via that interchange. The joint or proportional rate is deemed competitive if the revenue to variable cost ratio is not higher than that realized on the carrier's single line (or an existing joint line) rate.

Subsection (b)(1) amends section 11103(a) of title 49 U.S. Code (use of terminal facilities) to:

Require the ICC, upon certain findings, to grant any petition of a rail carrier, shipper, receiver, or other party directly impacted, for the use of terminal facilities (including mainline track for a reasonable distance outside of a terminal);

Broaden the application of the section to railroads in interstate or foreign commerce (now applicable to railroads subject to ICC's jurisdiction under Title 49 U.S. Code);

Expand the finding "practicable and in the public interest" to "practicable and necessary for the provision of alternative competitive rail service by the latter [using] carrier, or otherwise in the public interest";

Change the compensation standard from the principles applicable in a condemnation proceeding (generally, fair market value) to a level that ". . . shall not exceed the costs incurred by the owning carrier in making its facilities available for use by the other carrier (including both variable costs and an allocated share of the fixed costs and a reasonable return, associated with the facilities actually being used by the other carrier)."

Set time limits for acting upon petitions and compensation issues.

Subsection (b)(2) amends section 11103(c) of title 49, U.S. Code (reciprocal switching agreements) to:

Require the ICC, upon petition of any interested party, to limit compensation for "reciprocal switching" to the jurisdictional threshold (now 180 percent of variable cost) unless the carrier demonstrates that a higher level is reasonable and necessary;

Prohibit cancellation of a reciprocal switching agreement except upon 45 days notice unless the carrier demonstrates that continuation is not practicable or is unnecessary to provide alternative competitive rail service, and require suspension and investigation if a shipper has or would utilize the switching for a significant portion of its transportation;

Require rail carriers to enter into reciprocal switching agreements where necessary to provide alternative rail service; and

Prohibit consideration by ICC of revenue adequacy or competition other than direct rail competition in its determinations as to the use of terminal facilities or reciprocal switching.

1. The Issue With Respect to Joint Rates.—To require a rail carrier to establish a joint or proportional rate via any interchange with another carrier without regard to competitive or other circumstances is utterly unsupportable. It would apply to the railroad industry a standard that is not applied to any other American business. The comparative revenue-to-cost test for determining whether the joint or proportional rate shall be "deemed competitive" is likewise unprecedented and contrary to sound economics.

As in the case of the market dominance and contract rate issues, the railroads were able to work out an agreement covering competitive access issues with shipper representatives (NIT League and Chemical Manufacturers Association) in the Ex Parte No. 455 proceeding. That agreement, which the Commission has now adopted, contains the following features:

(1) With respect to the cancellation of through routes or joint rates, the railroad is to provide 45 days' notice and an explanation and justification to any affected party requesting it.

(2) Before bringing an action challenging a cancellation, any affected party must seek to resolve the dispute through negotiation with the cancelling carrier.

(3) The Commission must suspend for investigation when it determines that the affected party has or would utilize the route or rate for a significant amount of traffic and that the cancellation would eliminate effective railroad competition.

(4) The Commission shall not permit the cancellation if, after investigation, it finds it contrary to the competition policies of the Staggers Act or otherwise anticompetitive. In making these findings it may consider intermodal competition, it may not consider product competition, and the existence of geographic competition must be shown by clear and convincing evidence.

(5) In situations where a through route, rate, or reciprocal switching does not exist, the Commission shall prescribe the same on complaint of a party if it determines that the route, rate, or switching has or would be utilized for a significant amount of traffic, and that prescription is necessary to remedy or prevent an act that is contary to the competition policies of Staggers or is otherwise anticompetitive. The limitations stated above with respect to product and geographic competition also apply to prescriptions.

(6) The Commission's determinations with respect to the competitive effects of cancellations or prescriptions shall not be given res judicata or collateral estoppel effect in litigation involving the same facts or controversy arising under the antitust laws.

As with most compromises, the agreement reflected in the rule did not satisfy all shippers or all railroads. It did meet, however, the basic concern expressed by many shippers that they were not able to obtain redress for joint rate cancellations. If a shipper or carrier can show that it is affected and that the cancellation eliminates effective railroad competition, the Commission must now suspend and investigate the cancellation. And the shipper or carrier cannot be taken by surprise. It is given 45 days' notice and can obtain an explanation of how it will be affected and the justification for the cancellation. With the basic protection, a shipper or carrier can be assured that a grievance will be heard.

2. The Issue With Respect to Use of Terminal Facilities.—The C.U.R.E. proposal to require one railroad to grant to another the use of its terminal facilities without regard to the availability of competitive service from trucks or barges or the adequacy of existing connective rail service is plainly unwarranted. To limit compensation to the costs incurred by the owning railroad in making available the facilities used may well constitute a taking of property without just compensation in that it would take account of neither the full terminal costs nor the lost revenues.

The purpose in broadening the application of the terminal facilities section from transportation regulated by the ICC to "transportation in interstate and foreign commerce" is not self-evident but, presumably, it is intended to embrace exempt traffic. If so, it would not necessarily achieve its purpose since the exemption would probably also embrace section 11103. The proposal is interesting, however, for its revelation of the mind-set of the C.U.R.E. group. Since an inability to abuse market power is a requisite to exemption, there could be no valid economic basis for compelling a grant of trackage rights for the carriage of exempt traffic. Notwithstanding the fact that the C.U.R.E. members have availed themselves of intermodal competition (shifting much of their traffic to non-rail modes), profited from geographic competition (obtaining bids from different sources served by different railroads), and in their own operations taken advantage of product competition (e.g., by pitting producers of aluminum against steel, coal against oil, and plastics against glass), the only form of rail competition they can profess to see is two locomotives on adjoining sets of track running head-to-head.

3. The Issue With Respect to Reciprocal Switching.—The proposed amendments to the reciprocal switching provisions are equally egregious. They establish a special ratemaking regime for switching rates by authorizing the Commission to establish compensation for switching "at a level not to exceed" the jurisdictional level (currently a revenue/variable cost percentage of 180) unless the carrier "demonstrates" that a higher level is "reasonable and necessary."[12]

This provision contradicts the entire ratemaking concept established by the Congress in the Staggers Act. Under that Act rates below the jurisdictional threshold are conclusively presumed to be reasonable. The proposed amendment creates a rebuttable presumption that switching rates above the threshold are unreasonable. There is no economic rationale whatsoever for regulating the prices for rail service within a terminal area (switching rates) any differently than the prices for rail service between terminal areas (line-haul rates). The only explanation for the restraint imposed by this provision is an unbounded penchant for price controls—even in the face of unbounded competition.

Further evidencing that penchant, the bill goes on to create a presumption that the cancellation of a reciprocal switching agreement is anticompetitive by requiring the suspension and investigation of a cancellation upon the mere showing that a shipper has or would utilize the switching service. Under any reasoned approach the issue should not be the act of cancellation per se but whether the cancellation would eliminate effective competition.

Not content with its amendment imposing a ceiling on switching rates, C.U.R.E. also adds an amendment compelling rail-to-rail competition. That amendment would require the establishment, and prohibit the cancellation, of reciprocal switching wherever necessary to provide "alternative competitive rail service." Existing law permits the ICC to require reciprocal switching where necessary to provide "competitive rail service." With this amendment, the Commission would be foreclosed from considering the presence of truck competition even, for example, if the traffic were boxcar or TOFC/COFC traffic facing 100 percent competition from trucks.

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[12] Depending upon how the language of the bill was explained in the legislative history, a shipper could assert that the language gives the Commission jurisdiction to prescribe switching rates at levels below the 180 percent threshold.

In all of these areas where the underlying issue is the maintenance or creation of competition, the ICC's concern should be the prevention of anticompetitive conduct, and assuring competition where that is required in the public interest. If it is to pursue that concern in a manner that will contribute to the long-run viability of the rail industry, it must apply economically sound criteria and should not be bound or limited by statutory criteria having nothing to do with economic principles and everything to do with the narrow self-interests of some shippers.

The long-range impact of these amendments would not be to promote competition but to discourage railroad investment because no investor would continue to invest in plant if that plant were going to become community property or required to be used at fire sale prices.

I. The Abandonment Procedure Amendments (Section 10).—Subsection (a) of section 10 prohibits refiling for an abandonment within one year of a previous denial unless there is shown a substantial change in circumstance.

Subsection (b) extends the time period for investigation and subsequent action by 15 days. Any community affected by an abandonment is given an opportunity for hearing (absent a good cause finding) and the carrier must bear the cost of the hearing.

Subsection (c) provides that, in determining whether to allow an abandonment, the ICC is to rely on "financial data respecting the facility proposed to be abandoned rather than system-wide or industry-wide averages."

Subsection (d) provides that, in considering abandonment applications, the Commission is to disregard traffic losses occasioned by surcharges.

The refiling prohibition and time period extension are relatively unimportant but also unnecessary.

The hearing provision is pernicious. It would encourage a proliferation of hearings by allowing the Commission to opt out of conducting the hearings, to employ nonfederal employees for that purpose, and to charge all of the costs to the railroad seeking the abandonment—thus penalizing the railroad seeking abandonment of an uneconomic line. In the absence of any evidence as to the insufficiency of the existing hearing requirements, the creation of such a process is unwarranted.

The provision requiring the Commission to base its determination "upon financial data respecting the facility proposed to be abandoned rather the system-wide or industry-wide average" is, presumably, intended to preclude use of any unit costs based on system averages and would thereby impose unreasonable burdens upon the railroads. For example, locomotive costs are now determined on a system-wide basis. To require a railroad to monitor the types and ages of locomotives actually used over a two year period on a line proposed for abandonment would impose a substantial accounting burden. To require the same approach to each car used would create an enormous burden. Moreover, the process would be self-defeating because if the costs of special data collection were attributable to the line, the costs of maintaining the line would mount and enhance the likelihood of abandonment. If any changes to existing costing procedures for abandonments are warranted, such changes are appropriately accomplished through the regulatory process.

J. The State Authority Amendments (Section 11).—Subsection (a) of section 11 eliminates, as a condition to state regulation of railroad rates, a certification by ICC that the state's standards and procedures are in accordance with federal standards and procedures. The subsection would substitute a requirement that states need only regulate in a manner "consistent with" federal law. Any party to a state proceeding may petition from review of a state decision by ICC.

Subsection (a) limits the ICC's scope of review of state decisions to that of a reviewing court under the Administrative Procedure Act (generally deciding questions of law, review of record, and setting aside actions that are arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law).

Before the Staggers Act and its requirement that states regulate in accordance with federal standards and procedures, hundreds of millions of dollars in revenues were lost to the railroads annually due to state regulatory actions holding down intrastate rates, usually by inordinate delays in reaching decisions. These actions placed a clear burden on the railroads and their interstate shippers which the Congress set about to correct in Staggers.

The amendment not only wipes out the gains in Staggers, it fails to restore even the limited right carriers had prior to Staggers to seek recourse at the ICC for the intolerable delays in effecting intrastate rate increases as a consequence of dilatory action by state regulators. ICC could set a rate on review prior to the 4-R and Staggers Acts. Under this proposed amendment, the ICC could only vacate a state decision and remand for further action. Restoring to the states their pre-Staggers jurisdiction is plainly re-regulation, not "fine tuning." And to label as "fine tuning" an amendment that would deprive railroads of even their pre-Staggers remedies against unwarranted state action is blatant misrepresentation.

To sum up, the C.U.R.E. bill, S. 676, would not "fine tune" Staggers, it would repudiate Staggers. It would turn national policy away from the maintenance of a privately-owned railroad system and commit the nation ultimately to a nationalized system. As it did before Staggers, the Federal government can fashion a set of rail regulatory policies designed to give shippers a subsidized ride on the railroads. But only by ignoring the clear lesson of the 1970's can it do so and still expect to maintain the system through private investment.

As a premise for the drastic changes embodied in the C.U.R.E. bill, one would expect to find compelling arguments. I turn now to a review of the "cases" that have been made in behalf of the C.U.R.E. bill—and an examination of those making them—to show that such arguments do not exist.

IV. THE ELECTRIC UTILITIES' CASE

Because the railroad industry faces competition for most of its service, it must price down to that competition in order to retain its traffic base and exact a relatively larger contribution to its fixed costs from the less-competitive or "captive" traffic. One of the electric utilities' basic arguments has been that such differential pricing—charging shippers in accordance with their relative need for rail service—is unfair to the captive shipper and constitutes "monopoly pricing." More recently, it has moderated that argument and now acknowledges some need for differential pricing—at least up to the jurisdictional threshold.

The utilities' moderation of their position on differential pricing is no doubt prompted by a recognition of the increasing necessity for its use in their own industry. The following excerpts from a recent article by an attorney for Northern States Power Company makes the point: [13]

> Competition in the electric utility industry has intensified in some parts of the country. . . . If investor-owned utilities are going to retain their present position in certain wholesale and retail markets, they must have greater rate-setting flexibility.
>
> The fixed rate concepts devised for regulating investor-owned electric utilities during the 1940s, 1950s, and 1960s did not contemplate significant institutional competition.
>
> As a result of this competitive environment, efficient economic behavior, and fixed rate regulation, changes in market share and market segments are occurring to the detriment of the privately owned utility.
>
> Regulated electric utilities placed in a competitive environment must have the ability to respond to unregulated power suppliers in a timely and meaningful fashion or lose a valuable portion of the retail and wholesale market.
>
> One solution which would balance the realities of the marketplace and the concerns of regulators is to develop a zone of flexibility in which the utility could charge any rate the market would bear. A rate floor for electric service would be established below which the utility could not charge. . . . In simple terms, this rate floor would be set slightly above the cost of fuel, variable operation and maintenance, and losses. This rate floor would assure some contribution to the fixed cost of operation. . . .
>
> The economics of regulation in the electric marketplace has changed and regulation must change with it. Instead of the historic fixed rate, regulators should allow rates to reflect the competitive environment in which utilities operate.

Thus a utility spokesman makes the economic case for differential pricing of electricity service when faced with competition. But what makes basic economic sense for the electric utility industry, C.U.R.E. has, until recently, portrayed to the Congress as a travesty when practiced by the rail industry. Now feeling compelled to acknowledge the need for differential pricing of rail services, the utilities have turned their attention to means for limiting its extent.

They approach the problem in two ways: First, by rigging rate reasonableness determinations in favor of the shipper—shifting the burden of proof and creating a virtual presumption that rates in excess of the jurisdictional threshold are unnecessary. Second, by attempting to dilute the revenue adequacy standard for the railroads.

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[13] David M. Sparby, "Re-evaluating the Fixed Rate Concept for Regulated Electric Utilities," Public Utilities Fortnightly, October 30, 1986.

The electric utilities justify their assault on the Commission's revenue adequacy standards by suggesting that any railroad that is "profitable" is earning adequate revenues and is not entitled to increase its return on investment through rates charged "captive" shippers. In their own case, however, the electric utilities demand the right to charge their captive customers as much as necessary to enable the utility investor to earn the current cost of capital on its investment. Let us look at PEPCO—whose officers have frequently been witnesses for C.U.R.E.—as a case in point:

For the period 1980-86, PEPCO's earnings increased from $88.8 million in 1980 to $227.7 million in 1986, an increase of 156 percent. Earnings per share went from $2.10 to $4.58, an increase of 118 percent.

PEPCO's annual dividends increased from $61.8 million in 1980 to $124 million in 1986, a 100 percent increase. Accumulated retained earnings in that period increased from $206.3 million to $529.5 million, or by 148 percent.

The average return on equity in the electric utility industry in 1980 was 11.4 percent. So, with a 12.2 percent return in 1980, PEPCO was a very profitable company. But, being very profitable did not dissuade PEPCO from seeking to impose higher rates on its captive customers: In 1980 PEPCO asked for a $98.2 million rate increase and was granted $54 million; In 1981, it asked for $37.1 million and was granted $35.4 million; In 1982, it asked for $187.2 million and was granted $67.8 million; In 1983, it asked for $85.6 million and was granted $25.6 million; In 1984, it asked for $80.1 million and was granted $29.9 million; As part of the 1984 rate hike, PEPCO was told not to come back for more in 1985. In 1986, PEPCO sought an increase of $23 million in Maryland and was granted a decrease of $21.9 million.

PEPCO's return on equity grew each year, and by 1986 stood at 17.3 percent—and its whopping profits never once deterred it from asking for more from its captive customers. And it succeeded in getting more—at least up to the point where its profits had become an embarrassment.

The other major argument advanced by the utilities is that "skyrocketing" rail coal rates have driven up their costs. We provided the Committee with a study of that issue during the last Congress.[14] Some excerpts from that study bear repeating. The following quotation is from page 7 of Part II of the report:

While [electric utility] fuel costs relative to revenue fell from their 1981 peak, they did increase in absolute terms—costs in 1984 being $842 million (or 2.3 percent) higher than in 1981. Some of that increase was due to increases in the delivered price of coal and other fuels. (See Table 1) But, in the case of coal, the increased cost is due for the most part to increased consumption. As shown in Table 7, the utilities consumed 67 million more tons of coal in 1984 than in 1981—an increase of 11 percent.

But the crucial fact to note is this—while fuel costs were increasing by $842 million between 1981 and 1984, the utility industry's total revenues were increasing by $24.4 billion! Thus, only 3 percent of the increase in revenue went to pay increased fuel costs. Where did the rest go? More than $7 billion of it—or 29 percent—went to utility investors in the form of increased dividends ($4.1 billion) or increased retained earnings ($2.9 billion). All told, the contribution to investors rose from $12.7 billion to $19.7 billion.

Mark Cooper, an officer of the Consumer Federation of America, testified at great length before the Committee on behalf of that organization. While the C.F.A. professes to speak for consumers, on the Staggers Act issues it more obviously speaks for the utility industry—particularly for the American Public Power Association and the National Rural Electrical Cooperative Association, both of which are dues-paying members of C.F.A. and sit on its Board of Directors. This is evident from the fact that for several years now, the C.F.A. has been attempting to rivet the Congress' attention on the rail rate share of a 3 percent increase in utility fuel costs, rather than on the 29 percent increase in costs which electricity consumers paid to utility investors in that period.

It is further evident from Mr. Cooper's expression of outrage at the fact that on average over the period 1981-85 the Commission set the railroads' cost of equity 6 percentage points higher than the average return on equity of all manufacturing concerns. He presented a table showing the latter to be only 11.3 percent and the average of the S&P 400 to be only 12.8 percent. The cost of equity is determined by a well-accepted analytical methodology. By comparing average returns with the financial market's target means only that many manufacturing and S&P 400 firms did not meet the target. But, because it is an average, many others undoubtedly did.

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[14] "An Analysis of the Electric Utility Industry" prepared by the Association of American Railroads, July 1985.

Mr. Cooper might have noted—since he is working so closely with the utilities on the C.U.R.E. bill—that the average return on equity for electric utilities in 1985 was 14.4 percent—more than double the railroad industry's return of 6.83 percent. Obviously, with an average of 14.4 percent many utilities were earning well above that level. As a matter of fact, had he been interested he would have found one summary of 19 electric utility rate filings for 1985 showing requested rates of return ranging from 14.75 percent to 20.63 percent.[15]

Mr. Cooper's testimony also made much of the fact that two railroads had returns on equity in 1985 "about one percentage point" above the average for all manufacturing corporations. A recent study published by the National Association of Regulatory Utility Commissioners states that, *not a mere two,* but ". . . *roughly two-thirds* of all electric utility companies earned a higher return on investment than did the average stockholder of the major U.S. industrial companies over the 15 year period 1972–1986." [16]

We should not leave the examination of the electric utilities' case without recalling what happened to the "case" they relied on in the 99th Congress—the nineteen examples of how the railroads had allegedly abused their ratemaking power. The Committee will recall that the Department of Energy examined those cases at the utilities' urging. The result was reported in the Department's draft study of May 1985:

The study found no evidence that railroads have imposed 'abusive' rates on coal since 1980; average rail rates have increased less than 0.5 percent per year in real terms since then. . . . Admittedly, national statistics mask countervailing regional trends; some coal-hauling rates have decreased while others have increased. Yet, even in cases where rates have risen, the increases do not appear to have been widespread or of great magnitude.[17]

The Department's rejection of the utilities' best evidence of abuse prompted then-Secretary Hodel to write that same month to the Presidents of the Edison Electric Institute and the National Coal Association:

I know that there is an effort to try to cause Congress to do away with parts or all of the Staggers Act and restore ICC regulation to railroad coal rates. It would seem that unless someone can come up with some better evidence to support the case, we are not on the right track. That means that if you succeed, we cannot expect to solve the real problems of coal competitiveness by such a law change and we will have wasted time that could have been spent seeking real solutions.

V. THE COAL INDUSTRY'S CASE

The coal industry's basic argument for revising the Staggers Act is that rail rates have "skyrocketed" while coal prices have declined. With respect to export coal, it makes the further argument that rail coal rates are responsible for making U.S. coal non-competitive in foreign markets. Let's see how well this case holds up in the face of facts.

With respect to the principal complaint of the coal interests, it is clear from an examination of the data that rail coal rates are not, as they allege, the principal deterrent to the competitiveness of coal. Looking first at what has happened to coal prices and rail coal rates from 1972, the year preceding the OPEC oil crisis, through 1985, one finds that average U.S. mine-mouth coal prices jumped from $7.66 to $25.20 per ton, a run-up of 229 percent. In the same period rail coal rates increased somewhat less—214 percent—and nine percentage points less than the railroads' inflation rate so that in inflation-adjusted terms rail rates actually declined. In essence, the rail share of the delivered price of coal was less in 1985 than in 1972. Furthermore, rail coal rates declined by 2.5 percent from 1985 to 1986.

If the measure of revenue per ton-mile is used—which takes account of the fact that each ton of coal is now carried on average over 50 percent further than in 1972—the contrast between coal prices and rail rates is even greater. On a ton-mile basis rail coal rates in current dollars rose from 1.20 cents in 1972 to 2.28 cents in 1985 (latest data available)—an increase of 90 percent compared with a rail inflation rate of 223 percent and a coal price increase of 229 percent.

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[15] Public Utilities Fortnightly, January 23, 1986 at 66.

[16] "Electric Utility Shareholder Returns: 1972–1986," Michael Foley and Michael Eikenberry, National Associations of Regulatory Utility Commissions, March 13, 1987. (Emphasis supplied)

[17] "Effects of Railroad Regulatory Reform on Coal and Electricity," U.S. Department of Energy Staff Working Draft, at 2.

In terms of the more recent post-Staggers Act period, a comprehensive AAR study shows that railroad coal rates increased by 23.8 percent from October 1, 1980 (the date of enactment of Staggers) through September, 1986. That increase only slightly exceeds the 22.2 percent increase in railroad rates for all commodities, and is below the 28.5 percent increase in railroad inflation and the similar 28.4 percent increase in consumer inflation—all between October 1, 1980 and September, 1986. The reported increase in railroad coal rates equates to an annual average increase of 4.0 percent since the Staggers Act. In "real" (constant dollar) terms, railroad coal rates have declined by 3.7 percent since the Staggers Act.

Apart from the pace of coal rate increases, are these rates in any event excessive? In terms of revenue per ton, coal yielded $11.77 in 1986 as compared with $20.82 for all other traffic. In revenue per ton-mile, coal ranks dead last among the major commodity groups. While providing 22 percent of rail revenue, coal constituted 40 percent of the traffic. No more than 20 percent of coal moves at rates high enough to meet the revenue-to-variable cost threshold for ICC rate regulation.

Further—and compelling—evidence that the railroads have not abused the ratemaking freedom accorded by the Staggers Act is provided by the very limited use made by the railroads of their authority under Staggers to raise rates as much as 6 percent per year (reduced to 4 percent beginning October, 1983) over the inflation rate without suspension or investigation by the ICC. Increases actually taken under that authority amounted to .46 percent in 1981, 1.41 percent in 1982, 0 percent in 1983 and 0 percent in 1984. Comparable data is not available for 1985 and 1986, but the continued decline in revenue per ton-mile in those years suggests a continuation of the experience in 1983 and 1984.

With respect to the export coal market, it is quite evident that the cost of rail transportation is not the factor deterring the purchase of U.S. coal. Since the cost of rail transportation is generally a small portion of the delivered price, and since the U.S. is the high-cost coal producer by a considerable margin, the cost of rail transportation has a relatively small effect on the level of the U.S. coal exports.

The delivered price of coal from the various exporting countries depends upon several factors: production costs (mining, cleaning, blending, etc.), inland transportation costs (rail, truck, barge, etc.), ports costs, ocean freight costs, levels of government subsidies and taxes on coal, and international exchange rates.

In a report entitled, "Annual Prospects for World Coal Trade 1985," the Department of Energy analyzed the costs of the various components of the delivered price of steam and metallurgical coal to Europe and Asia. These data clearly demonstrate that rail transportation costs account for only a minor portion of the delivered price and could not be a major factor in determining demand for U.S. coal in the export market.

For example, for a deep mine in Appalachia, the Department found that the combined rail and port costs account for $16 of the delivered prices of $47–55 to Europe and $51–59 to Asia. If the rail and port charges in the U.S. were entirely eliminated, South Africa could still have delivered coal to Europe as cheaply as the U.S. Similarily, the delivered cost of coal from the U.S. to Asia, excluding rail transportation and port charges, exceeded the total delivered costs of coal from both Australia and South Africa. While differences in quality can affect the relative costs of these suppliers, the cost advantages of Sourth Africa and Australia appear overwhelming and cannot begin to be offset by the conceivable reduction in rail rates.

But, putting aside the facts, logic tell us that the only circumstances in which a railroad would refuse to set its rates low enough to permit U.S. coal to compete in an export market would be where the rail rate has to be set so low that the railroad would lose money hauling it—i.e., at a level below its variable costs. The railroad would have a clear incentive to move any coal which could be moved at any rate in excess of its variable cost because it would, thereby, gain some contribution to its fixed costs.

VI. THE PROCOMPETITIVE RAIL STEERING COMMITTEE'S CASE

The Procompetitive Rail Steering Committee (PRSC) is composed of 16 large companies whose principal objective is enactment of the so-called "competitive access" provisions of the C.U.R.E. bill. As noted earlier, the competitive access issue involves the circumstances under which carries should be allowed to cancel, or the Commission should be allowed to prescribe, joint or switching rates or to compel the grant of terminal trackage rights. To the extent these aspects of railroad operations are fully regulated by the Commission the antitrust laws are generally not applicable. However, because competitive issues are involved, the principles of antitrust law should be applied in addressing them. That view is embodied in the Commission's rules which provide, generally, that competitive access remedies such as prohibiting joint rate cancellations or prescribing the terms and conditions of reciprocal switching agreements will be granted where ". . . necessary to remedy or prevent an act that is contrary to the competition policies of [the Interstate Commerce Act] or is otherwise anticompetitive. . . ."

The principal dispute the railroads have with shippers such as those represented on the Procompetitive Rail Steering Committee (PRSC) is that, in seeking to extend their competitive access remedies, the shippers are not seeking relief from refusals to deal or other anticompetitive actions of railroads, but, rather, are attempting to turn the refusal-to-deal provisions of the Interstate Commerce Act into a substitute for the provisions regulating the level of maximum rates. The proof of this is the C.U.R.E. bill's provisions which require rail-to-rail competition regardless of the presence of truck, barge, or market competition.

The PRSC case needs to be examined both from the standpoint of the principle involved in the competitive access issue and from the standpoint of abuse of market power. Are the members of the PRSC being "abused" by the railroads or are they even likely to be?

A. The Principle Involved.—The principle at issue is whether a railroad is to be forced to share its services and facilities in the absence of any showing of anticompetitive conduct and at non-compensatory prices. Stated another way are the railroads' properties to be taken for public use without just compensation? For those who would use the competitive access provisions to convert the railroad infrastructure to community property, the Commission's decision of the *Midtec* case [18] has become a rallying point.

Midtec is the first case decided under the ICC's new rules governing the establishment and cancellation of joint rates and through routes and reciprocal switching agreements. As noted above, those rules provide for competitive access remedies such as reciporocal switching where necessary to remedy or prevent an act that is contrary to the competition policies of the Interstate Commerce Act or is otherwise anticompetitive. In its decision the Commission stated that it searched the record for evidence of anticompetitive conduct by the Chicago and Northwestern Railway and found none.

The Commission correctly viewed the Staggers Act references to the fostering of intramodal competition as being "directed to situations where some competitive failure occurs." The Act did not contemplate that the Commission would use its competitive access powers "to initiate an open-ended restructuring of service to and within terminal areas *solely* to introduce *additional* carrier service." (emphasis supplied) [19]

That an open-ended restructuring of the rail system is precisely the objective of the PRSC is made plain by the testimony of Mr. Zitto, the PRSC spokesman, in testimony before the House Committee on Energy and Commerce on May 20: "It is the firm conviction of the Procompetitive Rail Steering Commitee that only by extending competitive forces to all segments of the rail transportations (sic) market can shippers realize the full benefit of the efficiencies and cost-reducing incentives which have made the deregulation of other transportation modes successful."

There was and is no absence of "access" by other railroads to the Midtec plant in the form of joint rates and routes. In its testimony before the Commission, the Chicago and Northwestern set forth in some detail the joint rates and routes available to Midtec. (It also noted that 37% of Midtec's outbound and 39% of its inbound tonnage moved by truck.) The purpose of section 9 of the C.U.R.E. bill which the PRSC is promoting is not to assure access but rather to dictate the form and price of that access. It would, thereby, strip the owning railroad of the essential prerogatives attending private ownership of property—the price and terms upon which its property will be made available in a joint venture with another railroad.

Mr. Zitto's argument makes sense only if one does not think about it very long or very hard. Why shouldn't the railroads, like the airlines and motor carriers, be able to run wherever a shipper wanted them to run? I would suggest that one reason—and in my judgment it is conclusive—is the rights of private property owners under our economic and political system. The airlines do not own the airports which they use and they do not own the airspace and air traffic control system, the "highways" they use to connect those airports. And, of course, the motor carriers do not own the highway system they use. Neither has any sunk investment in the infrastructures they use. The operators can sell their planes or trucks tomorrow and simple walk away from the huge federal, state and local investments in the facilities on which they depend. The railroads are not so fortunate. Each owns its right-of-way and track which it must maintain and ultimately replace it if it hopes to stay in busness—and to do so it needs to recover its total costs. PRSC and other supporters of the C.U.R.E. proposal would have the Congress make public rights-of-way out of the railroads' private property at bargain basement prices. It is hard to believe that such a proposition could be so virgorously advanced by private enterprises—members of PRSC—such as Amoco, Cargill, Ethyl, International Paper, Libbey-Owens-Ford, Manville, PPG Industries, and Union Carbide.

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[18] *Midtec Paper Corporation, et al.* v. *Chicago and Northwestern Transportation Co.,* No. 39021, decided December 2, 1986.

[19] Id. at 3.

If, as the PRSC maintains, enhanced competition through forced rental of property or service is good public policy for the railroad industry then it is good policy for those industries who are members of the PRSC. Because all consumers would like to pay less for the goods and services they consume, the analogies are clear. For example, let's assume that a chemcial company (Chemco-1) manufactures a plastic at its own plant from certain building block materials and that plant has some excess capacity. Another chemcial company (Chemco-2) manufactures the building block chemicals, but has no plastics plant and the market for plastics is such that Chemco-2 could not recover the cost of constructing a plastics plant at prevailing prices. Following the PRSC's notion of good public policy, any customer of Chemco-1 who would like to get its plastics at a cheaper price should be permitted to invoke governmental powers to force Chemco-1 to permit Chemco-2 to use the excess capacity at Chemco-1's plant at a regulated price. That price, according to the PRSC, should be "limited to the costs incurred plus a reasonable profit." Obviously, to achieve its purpose of permitting Chemco-2 to produce plastics from its inputs and sell to the consumer at a price below Chemco-1's price, either the "costs" or the "reasonable profit" has to be reduced to a level below that which would be reached by voluntary negotiation between Chemco-1 and Chemco-2.

Or why not apply the same concept to barges owned by a firm such as Cargill—another of the PRSC members. In times of heavy grain movements, there is a shortage of barges and barge rates double or triple. Why not force all barge owners with any excess capacity to make their barges available to other users at the actual cost to the barge owner plus a "reasonable" profit rather than at the price the market would fetch.

And, of course, one would not wish to exclude the electric utilities since the competitive access provision which the PRSC finds so appealing is a creature of C.U.R.E. Why not communalize the electric transmission lines and let a consumer purchase power from any source while paying the owner of the transmission lines only the costs incurred plus a "reasonable" profit—and, of course, requiring the utility investor, rather than other utility customers, to bear the consequences of the lost revenue. That is the public policy implicit in section 9 the C.U.R.E. bill. If it would not be appealing when applied to the members of C.U.R.E. and the PRSC, neither should it be appealing when applied to the railroad industry.

B. The Issue As to Abuse of Market Power.—The best evidence of the absence of any abuse market power, and of why the PRSC is trying to drive down rail rates by competitive access rather than rate regulation, lies in the fact that they cannot show that rail rates are too high. The PRSC members include one shipper of paper products, several chemical manufacturers, one automobile manufacturer and one international grain company. In 1984, the last year for which data are available, only 1.56 percent of the total rail revenue derived from the transportation of paper products was derived from traffic moving at rates above 180 percent. In other words, 98.44 percent of the revenue from paper products came from rates below the jurisdictional threshold of 180 percent. For chemical products, 91.31 percent of revenue came from traffic moving below the jurisdictional threshold. For motor vehicles, it was 82.27 percent. For farm products, it was 96.36 percent. These are hardly numbers that suggest abuse of market power.

Yet, in his testimony, Mr. Zitto quoted a famous movie line: "We're mad as hell and we aren't going to take it anymore." Just what is it that Mr. Zitto has been "taking" that makes him so mad? The case he cites involves an alleged refusal by Guilford Transportation Industries—a conglomeration of small railroads put together by a risk-taking entrepreneur in an effort to maintain rail service in New England—to establish a "competitive" joint rate with the Canadian National Railway.

Mr. Zitto states that his company has filed a complaint with the Commission so there is a remedy available to him under existing legislation. In Appendix A to his statement, he notes that International Paper "is the world's largest forest products company with annual sales in excess of $7 billion." He further notes that the company operates 25 pulp and paper mills and over 153 manufacturing and converting plants "throughout the United States" and "is also a major producer of lumber, plywood and related products." With numbers like that one must truly wonder why International Paper needs even more stringent federal legislation to help it cope with Guilford's Springfield Terminal Railway. Is that a case that compels the Congress to amend the Staggers Act?

Leaving aside the relative economic positions of the International Paper Company and the Springfield Terminal Railway,[20] how much abuse is the company really subject to at the hands of any railroad? One can fairly assume that a company with annual sales in excess of $7 billion, 25 pulp and paper mills, 153 manufacturing plants, which is also a major producer of lumber, plywood and related products, and which operates throughout the United States, has either (1) a great deal of leverage with every transportation company it deals with, (2) a great number of competitive options, or (3) both. As a matter of fact, the International Paper Company has itself provided good evidence of the fact that it indeed does have both leverage and options.

An article appearing in the *Journal of Commerce* [21] reported on a "debate" between two International Paper Company officials on the "comparative merits of railroad vs. truck carriage." The company's truck spokesman is quoted as saying "We've got so much competition our biggest problem is learning how to deal with it and sort it all out."

The article then turned to the company's rail spokesman: "On the rail side, Mr. Granatelli said the 'crazy' marketplace has resulted in tariffs and list prices that are just a starting point today."

In response to Mr. Granatelli's statement that the future for rail haulage of paper looks good, the article quotes the company's truck spokesman as saying "Don't you believe it . . . . [Motor carriers] have proven themselves very adept at acquiring the right kind of equipment and putting it into service with us." The company's truck spokesman concluded by stating: "The railroads probably have a rather small window in which to react if they really want to preserve a paper market."

And that is the basis upon which the PRSC is asking the Congress to adopt the C.U.R.E. bill which would compel rail-to-rail competition in any market served by only one railroad and prohibit consideration of truck competition in that market? Those interested in preserving rail service ought to be "mad as hell" at that proposal.

But there is no need to single out the International Paper Company on this issue. International Paper is typical of the members of the PRSC in terms of size, transportation alternatives, and "clout" in dealing with those alternatives. For example, the FMC Corporation in 1985 had assets of $2.7 billion and sales of $3.3 billion. It is engaged in a wide variety of manufacturing including industrial and other chemicals, defense systems, and machinery and equipment in 112 plants.

Or take PPG industries. In 1985, it had $4.1 billion in assets and $4.3 billion in sales. It manufactures glass, chemicals, and coatings and resins and has plants in 21 states.

And Union Carbide, another member of the PRSC, had $10.6 billion in assets in 1985 and $9 billion in sales. It manufactures petrochemicals, industrial gases, metal and carbon products, technology services, specialty and consumer products and has plants in 23 states. With that volume of sales and diversity of product and plant location, it is not at anybody's mercy in the purchase of transportation services.

These giants of industry are, according to Mr. Zitto's testimony, demanding rail-to-rail competition in all markets because of the concentration that has occurred in the railroad industry. A couple of points are to be noted with respect to that argument. First, the rail mergers since 1980 have been, for the most part, end-to-end so competition has not been markedly decreased. Second, being end-to-end, they have enhanced the industry's efficiency, permitted more effective competition with motor carriers, and, in general, improved the quality of service. But let's look at what has been happening in our economy generally with respect to concentration. As long ago as 1975 (the last year for which data is available), 85% of the export grain market was controlled by only five companies. The 1982 census, now five years out of date, shows substantial concentration in most sectors of manufacturing. Some examples are listed in Attachment 2.

The fact is that, while the railroad industry has become more concentrated, so have its customers. To the extent concentration creates leverage, there is no reason to believe the railroads have gained more than their customers. The railroad system today accounts for only about one-third of all intercity freight traffic (and, by most measures, 85–90% of that share is subject to competition). There are ten Fortune 500 companies with revenues in 1986 greater than the combined revenues of the Class I railroads. Of the companies listed in the Fortune 500 with sales over $1 billion, there are 25 in metal and metal products, 29 in petroleum refining, 12 in building materials, 23 in chemicals, 33 in foods, 32 in electric utilities, and only 5 in railroads.

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[20] In 1986, International Paper had revenues of $5.6 billion and net earnings of $305 million. Guilford had revenues of $211 million and a net loss of $15 million.

[21] "Rails Vie With Truckers: Paper Firm's Executive's Debate Comparative Merits," Andrea Chancellor, *Journal of Commerce*, November 24, 1986.

The competitive access issue comes down to this: Where effective competition does not exist, are the level of rail rates to be regulated through maximum rate proceedings or through proceedings for compulsory transfer of property rights? Historically, rail rate regulation has recognized that many markets will not support two railroads. The imposition of additional rail service in such a market as required by the C.U.R.E. bill, without investment in the facilities necessary to provide such service, is not creating competition; it is forcing a landlord to lease his property or services at a non-compensatory price. If the federal government is to nationalize a privately-owned railroad infrastructure, it should not be by indireciton or inadvertence.

VII. THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONER'S CASE

The National Association of Regulatory Utility Commissioners (NARUC) supports the C.U.R.E. bill principally for two reasons. First, it sees no reason why railroads should not be regulated in the same manner as electric utilities. Second, it seeks a return and expansion of the powers which would permit each state's P.U.C. to do exactly that.

NARUC's arguments are the best evidence of the pernicious effects of the C.U.R.E. bill. Thus, NARUC argues: The ICC has adopted a regulatory program concerning monopoly rail service and the allocation of the revenue burden between monopoly and more competitive services which no State regulatory commission would employ in regulating the rates of utilities operating in similar situations.

A group of regulators who cannot perceive the difference between regulating monopolies and regulating an industry that is 85–90 percent competitive should not be entrusted with responsibility for differentiating.

The extent to which state regulators are incapable of discerning any difference between the railroad and electric utility industries is borne out by the resolution appended to their testimony before a House Subcommittee on June 3, 1987, in which they urge Congress to enact legislation which would impose the following standards for determining the reasonableness of rail rates: a. the cost to the railroad of providing the service involved; b. whether the traffic involved is paying an unreasonable share of the railroad's fixed costs; c. the impact of the rate on national energy goals; d. the extent to which railroad revenue shortfalls are attributable to hauling traffic at noncompensatory rate levels or failing to maximize earnings on competitive traffic; and e. price stability and impact on shippers.

Noticeable by its absence is any reference whatsoever to whether the railroad needs the revenue that the rate would yield. State regulation cost the railroads about $500 million a year before Staggers. The C.U.R.E. bill would sanction the recurrence of that calamity.

The NARUC testimony does not mention a single real problem that has arisen from the requirement in Staggers that states follow federal standards, if they are to regulate railroads at all. (Indeed, at last count, 25 states had completely relinquished authority to regulate intrastate rail rates.) One would expect that, if even one intrastate shipper had been aggrieved by Staggers in the past 7 years, NARUC could have found him by this time. The mere fact that singleminded monopoly regulators would like to start regulating railroads again as if they were monopolies does not justify a bill that would allow them to do so.

VIII. COMMENTS ON S. 816, S. 1026 AND S. 1040

S. 816 and S. 1026 would amend section 10901 of title 49, U.S. Code to require that an application (and any underlying agreements) for the acquisition or construction of an additional line of railroad be sent to the chief executive of each state directly affected and that the state be given 30 days in which to protest approval of the application. Upon receipt of a protest the Commission would be required to determine within 60 days whether an exemption of the transaction would be appropriate. If not appropriate for exemption, the Commission would proceed to determine whether approval of the transaction was in the public interest.

S. 1040 would amend section 10501 of title 49 U.S. Code to require the Commission in a case involving the sale, acquisition or abandonment of any rail line to or be a person who is not a carrier, to treat the person as if it were a carrier if the line involved exceeded 100 miles in length.[22] It would also require the Commission in any case involving a sale to a noncarrier of a line or trackage rights to take action as necessary to assure that the pre-existing level of service will not be lessened and that rates will not be increased except as permitted by increases in the rail cost adjustment factor.

Line sales to non-carriers are subject to Interstate Commerce Commission regulation under 49 U.S.C. § 10901. The ICC last year in Ex Parte No. 392 (Sub-No. 1), *Class Exemption for the Acquisition and Operation of Rail Lines Under 49 U.S.C. 10901,* 1 I.C.C. 2d 810 (1986), exercised its authority under 49 U.S.C. § 10505 to exempt from regulation most line sales. This class exemption allows the transactions to go into effect seven days after a detailed notice is filed with the ICC.

S. 816 and S. 1026 would, in effect, revoke the existing class exemption and require individual exemptions in each case. This would occur by virtue of allowing the affected states thirty days in which to protest the sale application [23] and requiring the Commission to decide whether or not an exemption was appropriate under section 10505.

The thrust of the bills is to reverse the findings of the Commission in Ex Parte No. 392 (Sub-No. 1). There, the Commission, drawing on its previous experience with line sales, issued a class exemption because it had concluded, based on experience, that the procedural requirements of the individual exemption process was unnecessary in the line sale context. Under this legislation, with its added disclosure requirements and its rigid thirty day comment period, section 10901 transactions will become more time consuming and uncertain. This can only work to the disadvantage of the parties involved and others interested in maintaining rail service.

For sales of over one hundred miles treatment under 49 U.S.C. § 10901 would no longer be permitted. Instead, such sales would be regulated as if the purchasing party was already a rail carrier and would have be pass muster under 49 U.S.C. §§ 11342-47 which governs the consolidation, merger, and acquisition of control of two or more carriers.

Unless the Commission granted an exemption, which the bill, unlike the two discussed previously, does not address, such transactions could result in lengthy proceedings, given the scope of inquiry mandated by 49 U.S.C. § 11344 and the procedural requirements of 49 U.S.C. § 11345.

More importantly, from the standpoint of the financial viability of the transaction, labor protection would become mandatory because the Commission may not exempt carriers from labor conditions that are prescribed as they are in 49 U.S.C. §§ 11344-4C.

The bill goes even further in reregulating line sales, for it also requires the Commission to take action to ensure that the level of service provided by the new carrier will not be substantially less than that provided prior to the sale. Also, rates on that segment of track could not be increased in an amount greater than the increase in the rail cost adjustment factor. Procedural short cuts and deregulation, as well as a lack of labor protection conditions, have greatly aided the popularity of line sales. This bill, even more so than the other two, would turn back the clock on progress made in all three of these areas, and could be expected to curtail to a significant extent any further line sale activities.

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS

Question 1. The industry has attributed many of its investments in improving track and related structures to benefits derived from the Staggers Act. Isn't it true that the tax laws and certain tax credits also played a significant role in these investments? Elaborate on the impact you feel changes in the tax laws may have on the industry.

Answer. During the 1981-86 period, Federal tax laws had a very significant and most positive impact on the improved cash flow of the railroads. As pointed out at page 2 of my formal testimony before this Committee on June 9, 1987, the Economic Recovery Tax Act in 1981 materially enhanced cash flows. Among other things, that legislation required a change in the railroads' method of tax accounting for track expenditures. While prescribing longer recovery periods for many future track outlays, it did permit a one-time recovery of past track expenditures which had not been depreciated. We estimate that one-time recovery of the so-called frozen base produced an estimated $2.5 billion in added cash through 1985. See pages 11 and 12 of the study appended to my June 9th testimony.

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[22] The bill refers to "abandonment . . . to or by a person who is not a carrier." As abandonments are meant to result in a permanent cessation of service, and only involve the abandoning carrier and no other party, perhaps the legislation is meant to apply to line sales funder 49 U.S.C. § 10905's financial assistance provisions, which occur after abandonments have been authorized by the ICC.

[23] In the case of S. 1026, any "interested party" could also file comments with the Commission during the thirty day period.

Similarly, the continuation of the investment tax credit produced almost as many savings during this period. And ACRS depreciation also was beneficial.

The principal benefits of the frozen base ended in 1985. Investment tax credits and ACRS were terminated last year so all of these sources of improved cash flow are now lost. Under the 1986 Tax Reform Act, we have estimated that railroads' Federal income taxes for 1986-1991 will be $2.5 billion more than under the rules existing prior to its passage if earnings remain constant. If rail earnings decline, the losses will be even more severe. Those huge projected cash drains stem from the elimination of the investment tax credit, less generous depreciation and a tougher alternative minimum tax—which overwhelm the gains made from lower corporate rates.

Moreover, those figures do not reflect the real possibility thast production by some of the railroads' capital intensive shippers (steel, mining and heavy machinery) will decline due to the harsher, new tax rules nor do they consider the stronger competitive positions of trucks and barges which, because of their less capital intensive nature, were less disadvantaged under the new tax laws.

On balance, the former tax laws and the Staggers Act were, as we have stated previously, both major contributors to the ability of the industry to reinvest in rail plant during the past six years. Having now lost most of those positive tax features, the railroads can ill afford to see the benefits of Staggers significantly reversed.

Question 2. The rail industry has expressed concerns about what it characterizes as high labor-related costs. Do you have comparison of these costs with those borne by your primary competitors, the truck and barge industries?

Answer. The average annual cost for a railroad worker is about $46,000 including fringe benefits. For our principal competitors, the motor carriers, the comparable figure is $34,000. For the barge industry, which is as heavily unionized as the rail industry, the comparable figure is $47,000.

Just as important as compensation levels—indeed, more important—are the many and serious restrictions on the productivity of rail employees. Work rules that have been overtaken by technology, for example, such as requirements for an excessive number of train crew members and rigid craft lines barring qualified employees from performing work other than that "belonging" to their particular craft. And labor protection either imposed by federal law—six-year full compensation guarantees in connection with railroad restructuring—or agreed to by railroads in order to secure the benefits of technological advances. The result is that, despite a 41% reduction in Class I employment since 1980, there remains a very substantial excess of employees receiving that average annual $46,000 in wages and benefits.

Question 3. You have testified that labor protection costs the rail industry approximately $338 million in 1985. Do you feel this was a representative year or might not these costs be declining as the industry completed the readjustments facilitated by the Staggers Act?

Answer. The figure for 1985 was based on a special survey of rail members and comparable data for other years is not available. If one assumes a decline in the number and extent of future restructuring actions, it would be correct to assume that these costs will decline as previous restructuring actions reach the six-year payout period. But that assumption may not be correct, and almost certainly will not be correct if the C.U.R.E. bill is enacted. The result of that bill. as I have testified, would almost surely be (1) an effort on the part of the railroads to shrink the rail plant as rapidly as possible in an effort to eliminate relatively low density lines, and (2) an effort to create further efficiencies by more consolidations.

QUESTIONS OF SENATOR ROCKEFELLER AND THE ANSWERS

Question 1. Please answer what seems to be a fundamental problem with the railroad business. You have testified that the railroads' traffic base is shrinking and you face very stiff competition from trucks. You also state that nearly all of the railroads' freight—80-90 percent—is competitive. It seems that much or all of the industry's problem is competition, not regulation. You also testified that your fastest growing segment of traffic, piggyback, pays only about 112 percent of variable cost, on average. Coal, by contrast, is a plentiful domestic resource with a large, still untapped world market, and foreign coal buyers are unanimous in their opinion that excessive rail rates are the single most important factor frustrating the marketability of American coal. So, on the one hand, the railroads are providing extremely low rates in a shrinking traffic base to increased piggyback market share, while leaving a profitably hauled commodity in the ground. Why does either of these marketing tactics make sense?

Answer. I cannot agree with the basic premise of the question, namely, "that excessive rail rates are the single most important factor frustrating the marketability of American coal." The Energy Information Administration of the Department of Energy provided some comparative data on mine and rail and port costs for coal in its report entitled "Annual Prospects for World Coal Trade 1985." For deep mine coal from Appalachia and Australia the report shows mining costs of $22 for the latter and, for the former, mining costs of $33 ($26 if non-union labor used). The rail and port costs for the Australian coal were $15, for the Appalachian coal they were $16. In other words, an $11 difference in the price of coal but only a $1 difference in rail and port costs. The same report showed Canadian rail and port costs of $16 to $18—further evidence that U.S. rail costs were not out of line.

It is generally in a railroad's interest to haul all of the coal it can haul at profitable rates—and I use the term "profitable" to mean at rates making some contribution to fixed costs—taking into account all of the competitive factors that may exist. Indeed, the data for 1984 show that about 20 percent of coal moved at revenue to variable cost percentages below 120, i.e., at rates comparable to the average for piggyback traffic. By the same token, it is in a railroad's interest to haul all of the piggyback traffic it can as long as that traffic covers its own costs and makes a contribution to fixed costs.

The fact is that the supply of coal far exceeds the demand for coal and, in the world market, U.S. coal is at a severe price disadvantage before it leaves the mine mouth. The railroads are no more able than the coal mines to absorb the price reductions which would be necessary to overcome that disadvantage.

Question 2. You have testified that only by cutting costs have the railroads stayed afloat. Haven't much of these cost reductions taken the form of shifting costs to shippers? Can you provide us with the number of shipper-owned railroad cars? Shipper-owned locomotives? Does the AAR have any estimate on how much money shippers have spent on upgrade loading or switching facilities?

Answer. When costs of transportation are shifted to the shipper through the shipper's decision to buy its own cars, the rate charged by the railroad is generally decreased by an appropriate amount. Indeed, it is commonplace for tariffs to specify two rates, the rate charged depending upon whether the shipper or the railroad supplies the cars. The electric utility spokesmen have made much of the fact that they often buy their own cars. What they do not say is that the cost of those cars goes into their rate bases as an asset and the cost of the investment as well as the return on the investment is borne by their rate-payers and they receive lower rail rates to boot.

As of July 1, 1987, there were 1,297,919 freight cars in the national fleet of which 429,509 were owned by shippers. Of those 429,509, only 50,497 were coal cars. The AAR does not have data on shipper-owned locomotives but the number would be very small since their use would be limited to in-plant switching.

Neither does the AAR have any estimate of shipper expenditures to upgrade loading or switching facilities. The question, however, raises a point worth noting. A shipper would not invest money to upgrade a rail loading facility unless it believed it could, through the sale of its product, recoup the cost of the upgrade including a market return on the capital invested. And there is no reason why a railroad should be expected to do so. If this nation expects to maintain a railroad system, those who use that system have to pay the costs of the system whether they do so directly by their own capital investment or indirectly through rates which adequately compensate railroads for their capital investments.

Question 3. The railroad chief executives who appeared before the Subcommittee all testified that they have virtually no captive shippers. Do you agree?

Answer. In terms of economic forces, yes. But, as a legal matter, as pointed out at the hearing, "captivity" is a definitional problem and it was acknowledged that the ICC's notions of "captivity" were more liberal than the railroads' notions. There are shippers with fewer alternatives than others or with alternatives that are more costly and, as to those, the railroads exercise proportionately greater market power. But, overall, there are relatively few shippers who have no other reasonable means of market access than rail and whose rates are unconstrained by geographic or product competition, or potential competition. As Mr. McKinnon pointed out, the fact is that both the railroad and the shipper are captive to the markets they are competing in.

Question 4. You testified that the 1986 Tax Reform Act will be harmful to the railroads. Doesn't that Act contain a windfall to help ease some of that harm? Railroads have accumulated large deferred tax reserves calculated at the old statutory rates, but will be required to repay those reserves at the new, lower rates. Therefore, there would appear to be a significant windfall in the transition to the new tax law. Please confirm if this is true and provide an estimate of the amount of the savings to the industry.

Answer. The 1986 Tax Reform Act contains numerous provisions affecting the level of future income taxes for railroad companies. Some of those are helpful, such as the lower rates you mentioned. Other are harmful. On balance, the Act appears to be a decided negative, the extent of which will depend on the level of rail profitability, the demand for rail services and the impact of tax changes on the railroads' competitors.

If rail earnings increase, the Act will be less punitive. On the other hand, if rail earnings continue to decline—as they have in the past two years, the railroads' tax liabilities will be much higher than they would have been under the old tax rules.

To be more specific, we estimated the impact of the 1986 Act on the railroad industry over the six-year period 1986–1991 with the assistance of Price Waterhouse & Co. Those calculations used a static level of demand for rail business and no change in earnings. Under that scenario, the industry's total Federal taxes will increase by $2.5 billion compared with taxes under the prior system. This increase occurs because the decrease in taxes due to lower rates ($2 billion) is completely overshadowed by a $3.1 billion loss due to the elimination of the investment tax credit, a $900 million loss due to longer depreciation and a $500 million increase due to the minimum tax provisions.

Lower earnings over the next six years will generate added taxes well in excess of the $2.5 billion as the benefits from lower rates decline and the impact of the minimum tax provisions escalate.

If earnings rise by 9 percent per year, the overall losses will diminish but the 1986 Act will still cost the industry $900 million more over six years than the tax rules it supplanted.

To compound the direct penalties of the Act, many rail customers are also capital intensive industries which will see their activities curtailed by the loss of the investment tax credit and less generous depreciation.

Finally, the Act treats rail competitors such as trucks and barges in a less damaging fashion. Being far less capital intensive since Federal and state governments provide the capital for their rights-of-way, these carriers will face significantly smaller new tax burdens than will the railroads.

In effect, the Act is a triple whammy for the railroads—it reduces the demand for rail services by key rail shippers, it reduces the relative costs of the railroads' competitors, and it increases the taxes on what profits the railroads manage to retain.

Question 5. When you say that the railroad industry is disinvesting out of the railroad business, you imply that this is not a positive development. Have the railroads made inadequate capital improvements in their physical rail structures since the Staggers Act? If so, how much more should the industry have invested in the rail business since 1980? Is the railroad physical plant, or a part of it, deteriorating today due to inadequate capital improvements? Is the railroad physical plant, or a part of it, unsafe?

Answer. Railroads have been disinvesting in recent years by retiring and selling assets which have not provided, and do not give promise of providing, an adequate return on investment. Disinvestment is not a positive development because it is a clear sign of inadequate earnings, and if earnings do not improve, the trend could continue to the point where the "critical mass" of railroad service is threatened. This is not to say that the disinvestment does not have positive components, for in fact, it has at least two positive elements. First, uneconomical assets have been disposed of, thereby making railroads more efficient and potentially more effective in competing for traffic, and (2) opportunities have been provided to local and regional railroads which, with lower labor costs and other advantages, have maintained service which otherwise would have been lost.

The railroads have not made inadequate capital improvements since Staggers. The point is that they have made improvements only to those segments of the system where there is some hope of recovering the investment—and, as evidenced by the disinvestment which has occurred, those segments are shrinking in number.

The plant the railroads are retaining is not deteriorating due to inadequate capital improvements. This is due in large part to the fact that (1) economically marginal lines have been sold to lower cost operators and uneconomic lines have been abandoned, (2) capital requirements for equipment in the past six years have been lower than past or future levels because of equipment surpluses, declining business, and productivity gains, and (3) the now lost advantages of the old tax laws—particularly the write-off of the frozen base—covered a large part of the railroads' reduced capital needs in the past six years.

The rail plant is not unsafe. Federal safety regulations require that the plant be maintained to standards commensurate with the level of operation. Those standards are strictly observed. Where revenues from a line are insufficient to warrant maintaining track to the standards required for the highest level of operations, the operational level is reduced.

Question 6. It would also seem that investment in other businesses is also a result of the shrinkage in the railroad business that has taken place. How many jobs has the industry eliminated since 1980, and what percentage of the workforce was that? How many miles of track has the industry abandoned since 1980, and what percentage of the track was that? How many miles of track has the industry sold to shortlines or non-major railroads since 1980, and what percentage of the track was that?

Answer. The U.S. freight railroads have undergone a significant restructuring in recent years due to increasingly strong intermodal freight competition within an economy which has become progressively more service-oriented (as opposed to production-based). Plant, rolling stock, and employment levels are being rationalized in an effort to improve economic efficiency and productivity.

The reduction in railroad jobs since deregulation has been unprecedented. In 1980, Class I railroad employment was 443,700.[1] As of 1986, Class I employment totalled 275,800, a reduction of 38 percent, or 167,900 employees. From a total industry perspective,[2] the Railroad Retirement Board shows a similar 36.5 percent decline in employment (1980–1986) to 338,000 in 1986. Moreover, numerous larger railroads have announced plans for further worker reductions, with some individual carriers anticipating reductions as extensive as 13,000 people over the next several years.

Rationalization of the rail network has been a continual process since the 1920's, when miles of road peaked at approximately 250,000. By 1980, railroads had reduced their systems to about 175,000 miles of road. Since 1980, Class I carriers have greatly accelerated the rationalization process through permanent abandonments as well as the sale of trackage.

Railroads must obtain approval from the Interstate Commerce Commission before they may abandon or sell a line. During fiscal years 1981 through 1986, the ICC granted 1,269 abandonment applications encompassing 15,790 miles of road—9 percent of the total 1980 route mileage (Table 1).

TABLE 1.—RAIL LINE ABANDONMENT APPLICATIONS APPROVED BY THE ICC

	Number of applications	Miles of road
Fiscal year:		
1981	81	1,342
1982	381	5,151
1983	123	2,454
1984	419	3,083
1985	148	2,343
1986	117	1,417
Total	1,269	15,790

Source: ICC Annual Reports to Congress, 1981–1986 (Appendix B, Table 5 or 6).

As this decade has evolved, the larger U.S. railroads have increasingly transferred rail mileage by selling to entrepreneurs, municipalities, shipper groups, and other railroads. This concept of line sales has spread to the point where it is practiced to varying degrees by generally all the larger Class I carriers. Table 2 illustrates that 148 new railroads—almost one-third of the railroads operating today—have been established after 1980. These railroads have preserved service over 11,153 miles of road, or more than 6 percent of the 1980 U.S. rail network.

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[1] As reported by Class I railroads to the Interstate Commerce Commission. This figure is computed for the railroads which had Class I status as of 1986, since several carriers were declassified between 1980 and 1986 due to their relative decline in freight revenues.

[2] From the U.S. Railroad Retirement Board's monthly reports of Selected National and Railroad Data. Includes the approximately 475 non-Class I roads and various rail industry associations, bureaus, and other non-operating companies.

TABLE 2.—RAILROADS ESTABLISHED SINCE 1980

	Number of carriers	Miles of road
1981	9	494
1982	24	1,630
1983	22	514
1984	26	1,664
1985	29	2,385
1986	30	3,496
1987 (1st Quarter)	8	970
Total	148	11,153

Source: Association of American Railroads, "Profiles of U.S. Railroads."

In addition to the sale of excess or uneconomic rail mileage to newly-formed carriers, railroads have also sold track over the past six years to existing railroads which were established before 1980 as an extension or "add-on" to their existing physical plant. Included in this category would be, for example, portions of the liquidated Rock Island Railroad and the Milwaukee Road.

Question 7. How much money has the industry invested in piggyback, or TOFC/COFC, since 1980? What has been the industry's return on investment (ROI) on piggback since 1980? How much of the railroads' total capital investment (calculated at both book and market value) is in piggyback-related facilities?

Answer. The individual railroads do not report, nor does the AAR collect, data which allows it to identify the total investment in, or profitability of, rail piggback (TOFC/COFC) service. While industry-wide investment figures are available for intermodal facilities and equipment, excluded from these figures is the intermodal share of such fundamental asset accounts as track, roadway, locomotives, and structures other than TOFC/COFC. Likewise, absent from the railroad reported investment is the industry investment in intermodalism through Trailer Train—a company owned by 18 railroads for the purpose of supplying and administering a pool of "free-running" TOFC/COFC flat and other cars. Trailer Trains owns 80-85 percent of the total railroad intermodal car fleet.

Profitability of intermodal service is not available at the AAR because the needed investment, other cost, and reliable revenue data are not available. However, a word of caution is offered in interpreting revenue-cost ratios to be a surrogate for return on investment. Revenue-cost ratios are ratios of revenue to average, variable cost, including a return on investment at the embedded cost rate. Those ratios do not include coverage of fixed costs nor do they reflect the full, true costs of capital. In this regard, for any specific component of traffic, these ratios may be substantially above incremental or marginal cost, and also provide significant returns on investment.

Question 8. The dim picture you paint of the industry does not appear to be shown in the individual companies annual reports and filings with the SEC, and the discussions in those documents about their railroad properties. Please explain this discrepancy.

Answer. The dim picture of the railroad industry portrayed in the documents presented to you is an accurate projection of the financial condition of the railroad industry. We have focused on the present adverse conditions of railroads because of the continued threats to the industry by those who propose to increase Federal economic regulation of railroads. Thus, our purposes was one of pointing out to public policymakers that the railroad industry is a highly competitive industry which cannot withstand unnecssary, and costly, additional government controls.

Our review of the railroad corporate annual reports also reveals a picture which is not bright and glowing with success. In some of the reports, financial improvements have been noted, but these improvements compare with low earnings in prior years, and are still short of the returns that investors earn in other industries. In the last two years, those evaluations have become decidedly dimmer. The majority of railroad annual reports which we reviewed use such words as "flat," "no growth," and "declining," to describe their traffic levels. They are virtually unanimous in acknowledging significant price declines and drops in their average revenue per ton-mile. And they readily acknowledge the problems in their marketplace—the decline of smokestack industries, the competition from foreign markets, and the downsizing of products. Furthermore, a number of annual reports comment on the significant negative effect of the Tax Reform Act of 1986. The increase in railroad taxes results from the loss of investment tax credits, the harsher minimum tax and the new rules regarding depreciation. In no railroad corporate annual report are returns on investment shown to be adequate, or even comparable with other industries with similar risks of investment.

Question 9. You have testified that any business that cannot earn its cost of capital is doomed to go out of business, that piggyback traffic, your fastest growing traffic, pays only about 112 percent of variable cost on average, and that on average the railroads must charge 152 percent of variable cost to earn the cost of capital. You have also testified that those piggyback rates are set by competition and therefore cannot be unilaterally increased. What do the railroads propose to do in the short term and the long term to make piggyback traffic earn its cost of capital?

Answer. To the extent that economies of scale and density exist in the railroad industry, piggyback traffic carried at rates in excess of the variable costs of transporting it makes a contribution to fixed costs and is "profitable" traffic. To the extent piggyback traffic requires new investment, then the rates charged must also be sufficient to provide an adequate return on that investment over the long term. I am confident that, to the extent of new investment, the railroads are anticipating rates sufficient to cover the cost of the capital being invested. To the extent that anticipation is not realized, I am equally certain that rail managers would scale back investment.

The fact that on average piggyback traffic moves at only 112 percent of variable cost does indicate very strong competitive pressure. But that does not rule out the possibility of rates sufficient to cover the cost of new investment for some of that traffic given the very large economies of scale and density that exist in the railroad industry.

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question 1. Many have charged that some Class I lines are divesting themselves of large regional segments merely as a means of escaping labor protection or as a more politically expedient means of abandoning unwanted track. What is your response to those statements?

Answer. I believe such statements confuse the issue. While it is true that the imposition of labor protection might impose such heavy costs as to foreclose a line sale, the imposition of labor protection on an abandonment is not a sufficient motivation for a line sale. The existence of a buyer for a line indicates that a line remains potentially viable, given the ability of the buyer to reduce operating costs and more effectively market the service. Most lines that reach the abandonment stage have lost that potential. Thus, the line sale is an option which benefits the shipper, the selling railroad and employees. Service is maintained for the shipper and traffic is maintained (and usually increased) for the seller along with proceeds from the sale that would normally exceed the liquidation value obtained in an abandonment. Jobs that would otherwise be lost are also retained.

Question 2. I am concerned that regional "spin-offs" not be used as a back door abandonment tool. Presently, the buyer and seller simply file a notice to the ICC, wait seven days, and go forward with the transaction without any real opportunity for the local community or other interested parties to know who will be operating the new railroad. Do you think the government should have any role in making certain that the acquiring entity in a regional "spin-off" is a technically and financially capable operator?

Answer. The process by which a carrier may sell regional "spin-off" lines to which the question refers is a result of the ICC's decision in Ex Parte No. 392 (Sub-No. 1) *Class Exemption for the Acquisition and Operation of Rail Lines under 49 U.S.C. 10901,* 1 I.C.C. 2d 810 (1986). There the ICC, drawing on its previous experience with spin-off sales, decided to exercise its exemption powers pursuant to 49 U.S.C. § 10505. In the Staggers Act Congress had expanded these powers and urged the ICC to use them whenever it felt regulation was necessary. In this instance the ICC determined that the regulatory hurdles erected by 49 U.S.C. § 10901, the statute which, among other things, governs line sales to non-carriers, served no real purpose, and in fact delayed and, in some cases, prevented, the sale of viable rail lines to worthy operators.

While it is true the truncated approval process described in the question is shorter and contains less procedural mechanisms than a contested abandonment application would, there are many factors which mitigate against the use of the line sale process as an abandonment device. The first is the ICC's practice, codified at 49 C.F.R. § 1150.32(c), of declaring any exemption void ab initio if the notice contains false or misleading information. In addition, the exemption statute, under subsection (d), reserves to the ICC the power to revoke an exemption if the circumstances call for it. With these two tools the ICC can adequately police the line sale process for abuses.

Regardless of the regulatory preventives, however, there are present in the railroad environment structural considerations which make the use of the line sale process an ill-advised replacement for abandonment. While carriers will resort to abandonment when a line fails as a going concern by not returning to the carrier in revenues that which has been invested in it, the large capital expenditures sunk into an abandoned line, such as road and track property and equipment, still can prove valuable for a carrier, either through deployment on lines of greater profitability or by being sold and converted to cash. Consequently, carriers do not let go of these properties cheaply, as can be seen in the multi-million dollar purchase prices charged for some of the regional spin-off lines.

The high entry cost of operating a regional railroad ensures that only serious entrepreneurs who are intent on long term success will choose to make the necessary investment. That regional spin-off lines are viewed as viable enterprises is further envidenced by the participation of such prestigious investment banking firms as First National Bank of Boston and Irving Trust and by the recent interest of venture capitalists. Parties such as these will not waste their funds in enterprises lacking technical and financial capability.

These new owners do not take over a line of railroad without first doing in-depth research into the feasibility of operating a line, which entails much contact with "interested parties." Accordingly, in many cases, shippers and labor and community representatives have been contacted months in advance of the sale, thereby allowing the new carrier a headstart in developing good relations with these parties.

It is unlikely that a community will suffer from the substitution of a small carrier for a larger one where economically marginal lines exist. The smaller operator has a greater stake in the community and is better able to work with local industries to develop the traffic necessary to the maintainance of rail service.

Finally, it is in the interest of the selling carrier that the new operation remain viable. The larger carrier will still depend on that line to feed traffic to the rest of its system. Only by selling the line to a capable operator can it ensure that the line produces the traffic which moved on the line prior to the sale.

Question 3. In the past, I have expressed some interest in FELA reform. I know the railroads and labor have been discussing this issue. Is there any chance for compromise on this issue?

Answer. The question asks about a compromise on FELA "reform." I do not think there is any possibility for compromise on reforming the FELA. The compensation of employee injuries under tort law as required by the FELA is an unredeemably bad system and the FELA should, therefore, be repealed. I would hope that, because a no-fault workers' compensation system is demonstrably superior to the FELA for both employees and management, an agreement to substitute such a system for the FELA is possible.

Question 4. I have seen some pretty ominous statistics on the problem confronting—or soon to confront—the railroad retirement system. What is it going to take to make that system solvent for the long term?

Answer. Any retirement system in which one worker is supporting three beneficiaries needs radical surgery. Unlike most private pension systems, the railroad retirement system is as much a creature of the Congress as it is of management and labor and some of the financial problems being experienced by the system are directly attributable to actions of the Federal government. Consequently, the railroads alone cannot, nor should they be expected to, solve the system's problems. Similarly, current employees cannot bear the full brunt of the corrective actions that will be necessary. Those presently on the retirement rolls will also have to shoulder some of the load. Just how these burdens should be apportioned requires careful and thorough analysis. I believe it is a task for which a Presidential Commission is best suited and have urged the Congress to create such a Commission. The Ways and Means Subcommittee on Social Security on July 1, 1987, as part of its budget reconciliation recommendations, approved the establishment of a seven-member Commission on Railroad Retirement Reform "to perform a comprehensive study of alternative methods of securing the long-term viability of the railroad retirement system."

QUESTIONS OF OTHER SENATORS AND THE ANSWERS

Question 1. You have previously expressed your belief that enactment of S. 676 could effectively place a cap on rail rates. Please elaborate on this.

Answer. The C.U.R.E. bill would achieve the effect of capping rail rates by its terms and by presumptions drawn from its terms. It is a canon of legislative construction that courts will not deem the Congress to be engaged in idle acts. Courts presume that if a section of a law is changed it was done with a purpose and they attempt to discern and give effect to that purpose.

If the Congress were to enact the C.U.R.E. bill, it would effect the following changes in existing law with respect to determining reasonable rate levels:

(1) Prescribe a new policy of encouraging and promoting "competitive transportation rates for domestically produced coal and other commodities and products in order to increase their competitive position in both domestic and export markets."

(2) Delete the provision which now requires the ICC to "recognize the policy of this title that rail carriers shall earn adequate revenues."

(3) Add a provision which substitutes for the foregoing deletion a requirement for affirmative findings as to a railroad's need for the opportunity to achieve revenue adequacy, as to a railroad's need for rates in excess of the jurisdictional threshold (now 180 percent of variable cost), as to the relationship of the rate to cost of service (implicitly denigrating the reasonableness of demand-based pricing), and as to the efficiency of the railroad's entire rate structure (the Long-Cannon factors).

(4) Add a provision which shifts the burden of proof as to the reasonableness of a rate from the shipper to the carrier in cases where the rate has gone into effect without suspension or investigation by the ICC (the carriers already have the burden where the ICC concludes that evidence of the unreasonableness of a proposed rate warrants investigation of a rate before it takes effect). The burden would extend to all of the newly-required affirmative findings noted in item (3) above.

Having practiced law for many years, I have no doubts as to how these legislative changes would be used by counsel for shippers in rate reasonableness cases. They would argue that the new law plainly created an implied presumption of the unreasonableness of rates in excess of the jurisdictional threshold. What else could the Congress have been trying to do by telling the ICC that (1) it was now a prime national policy that the competitive position of coal be considered in determining the reasonableness of rail rates (i.e., railroads should subsidize coal producers), that (2) in determining rate reasonableness the ICC was no longer to recognize the policy that railroads "shall earn adequate revenues" but, to the contrary, it was to determine whether a railroad even needed the opportunity to earn adequate revenues, that (3) it should question whether a railroad needed to charge rates above the 180 percent threshold, that (4) it should give explicit consideration to the cost of rail service (while conspicuously omitting any requirement that the demand for rail service be considered), and that (5) it should require evidence from the railroad sufficient to support affirmative findings that it is not transporting any traffic at rates which did not contribute to going concern value, that other traffic was being charged as much as possible, and that no commodity was paying an unreasonable share of the railroad's overall revenues? The icing on their argument would be that the Congress did all of this with full knowledge that the industry's earnings were substandard but that it considered it necessary in terms of public policy to further restrict the railroads' ability to sustain even that level of earnings.

I believe both the ICC and reviewing courts could be led by such an argument to discern a plain congressional intent to place a heavy burden of proof on a railroad to show that any rate in excess of the jurisdictional threshold was reasonable, and that the end result would be an effective cap on rail rates—particularly rail coal rates—and sharply lower rail earnings.

Question 2. As you know, under current law, shippers have the burden of proof on rate reasonableness. In order to successfully challenge a rate, a shipper must prove that the rate is unreasonably high. Given that the railroads hold all the information on this, do you feel this is a reasonable burden to place on shippers? Similarly, why do you feel a shifting of the burden under S. 676 would be so onerous on the railroads?

Answer. As indicated in my response to the previous question, the shippers do not now have the burden of proof as to rate reasonableness in all instances. Under existing law, the assignment of the burden of proof turns on the distinction between complaints challenging proposed new or changed rates and complaints challenging rates that are in effect. Whenever a rate charged a shipper is to be increased, or a rate for a new service is to be established, the shipper is given notice and an opportunity to protest the change and to seek its suspension and investigation. If the Commission finds market dominance and decides on the basis of the shipper's protest to suspend and/or investigate, the carrier has the burden of proving the proposed increase is reasonable.[1] If, based on the carrier's response to the protest, the Commission refuses to suspend and/or investigate, the shipper is given a second bite at the apple—it may file a complaint after the rate goes into effect. In taking the second bite, however, the shipper also assumes the burden of proof.

Under the proposed bill, a shipper could protest any proposed rate increase and if, based on the carrier's response, it failed to secure an investigation, it could file a complaint. However, instead of having to come forward with evidence as to the unreasonableness of the rate, it could sit back and require the railroad to come forward again with evidence as to the reasonableness of the rate. If the shipper was not sanguine about the prospects of effectively rebutting that evidence, it would simply withdraw its complaint. Thus, for every rate increase subject to the jurisdiction of the Commission, a shipper could put a railroad through the regulatory wringer twice simply by filing two pieces of paper—complaints before and after the rate takes effect.

The existing apportionment of the burden of proof has been in place for most of this century. It comports with the general principle that the moving party carries the burden and, to my knowledge, no serous question as to its farirness has been raised before now. It is raised by C.U.R.E. as part of C.U.R.E.'s argument that railroads should be regulated like electric utilities and, because the utilities have the burden of proof as to their need for proposed rate increases, so should the railroads. But that argument conveniently overlook the fact that, in the same circumstances—i.e., the pendency of a proposed rate increase—the railroads do have the burden of persuading the ICC that there are no grounds for an investigation. Failing that, the railroads have the burden of proof in the investigation. Only after a rate becomes effective does a shipper challenging the rate have the burden. And in that respect, too, the railroads are like utilities because a customer challenging a utility rate that had been allowed to go into effect would have the burden of proof.

As to how onerous to the railroads such a shift in the burden of proof would be, I refer to my answer to the first question in this set. By creating the need for affirmative findings on a wide range of matters the burden would be an exceedingly heavy one. But leaving the weight of the burden aside, why should the railroads be treated differently than all other defendants in our legal system by being required to carry the burden of proof in complaints brought against actions they have taken? In the cases with which C.U.R.E. is concerned, the complainants have legal and analytical resources equal or superior to those of the railroads. There can certainly be no doubt as to their capability of bearing the burden.

Question 3. You have characterized Section 9 of S. 676 as providing trackage rights at "non-compensatory" prices. Can you explain this further, as well as your objections to competitive access as identified by the NIT League and the Procompetitive Rail Steering Committee?

Answer. Existing law provides that where trackage rights are imposed and the parties cannot agree on compensation, the compensation shall be established by the ICC "under the principle controlling compensation in condemnation proceedings." (49 U.S.C. 11103(a)) The compensation principle guiding condemnation cases can be simply stated—the owner is to be put in as good a position pecuniarily as he would have occupied if his property had not been taken.

Section 9 of the C.U.R.E. bill would delete the above-quoted standard of compensation and, in lieu thereof, provide that compensation ". . . shall not exceed the costs incurred by the owning carrier in making its facilities available for use by the other carrier (including both variable costs and an allocated share of the fixed costs and a reasonable return, associated with the facilities actually being used by the other carrier)."

Two of the implications of this change are obvious. First, the Congress would be expressly rejecting the condemnation standard which makes the owner whole. Second, it would be adopting a cost-based standard which takes no account of the revenue lost by the landlord carrier and which limits the costs to be borne by the tenant carrier to those associated with the facilities "actually being used." The latter ignores the fact that a railroad is a "system" and, although each shipper does not use each element of the system, each benefits from the existence of the entire system because it creates economies of scale.

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[1] The Commission may not suspend or investigate a rate increase that does not exceed 4% above the railroads' inflation index unless the rate as increased equals or exceeds 190% of variable cost.

Under the formula of section 9 it is quite likely that trackage rights would be sought only for the purpose of serving the most profitable traffic. This "cherry-picking" would very likely take from the landlord carrier revenues disproportionate to costs, otherwise neither the tenant carrier nor shipper could gain from the transaction. The wide-spread practice of cherry-picking would ultimately weaken, if not destroy, the entire rail system because its effect would be to severely restrain the differential pricing necessary to recover total rail costs. The probability of that result is the basis for our objection to both the C.U.R.E. and NIT League proposals.

Senator EXON. Thank you, Mr. Dempsey.

Mr. Breslin.

Mr. BRESLIN. Thank you, Mr. Chairman. My name is Frank R. Breslin. I am director of transportation for Scott Paper Company, headquartered in Philadelphia.

I have already provided my full statement for the record, and I would like to use this time to summarize my comments.

I am appearing here today on behalf of the Committee Against Revising Staggers, known as CARS.

CARS is an organization of over 400 shippers of all sizes, having grown by 25 percent since S. 676, the current CURE bill, was introduced.

Our members range from small, family-owned enterprises, to large companies, with headquarters in 42 states, and is reflected in a list of members that I have already provided.

The purpose of my appearance today is quite simple. It is strictly to urge that no legislation to revise Staggers be adopted at this time.

Gentlemen, I have been involved in the transportation industry for approximately 30 years. In all those years, I have seen the evolution of rail transportation to the point where, since Staggers, it has achieved a level of excellence, productivity and profitability that is unparalleled in our time.

And this has been transmitted with similar benefits to the consumers.

Because of the success of Staggers, I find it frustratingly difficult to understand why anyone would even remotedly consider any legislative modifications to Staggers at this time.

Am I alone in this thinking? I think not. The mere recognition of the depth and breadth of the members of CARS membership is significant in itself, in reflecting a broad base of enlightened shippers who believe strongly in the shared benefits of Staggers.

How do we, as CARS members, believe passage of the CURE bill would affect the users of the rail industry? Mr. Chairman, that is easy. We believe it would be disastrous.

Each of you represent constituencies from around the country where the heritage of rail transportation has deep roots. Because of this, you will surely recall the names of railroads of the past.

The Rock Island went bankrupt. The Milwaukee went bankrupt. The Delaware & Hudson went bankrupt. So did the Boston and Maine. So did the Redding. The Central of New Jersey. The Lehigh Valley.

And eventually, two of the finest railroads that ever existed, the Pennsylvania and the New York Central, after they merged into the Penn Central.

They are all gone, and so are a lot of others. The question is why. Because they were unable to change with the time, due to the Federal legislation that was archaic, anachronistic, inefficient, and anticompetitive.

It is a shame, but it is true.

Probably the Pennsylvania, eventually the Penn Central, is an example of making almost heroic efforts to survive in its last days, but still couldn't, due to the burdensome regulation.

Unfortunately, relief just did not come in time, and we wound up with massive rail bankruptcies, loss of thousands of jobs to the carriers and shippiers alike, great disruption of service, and in the east, the eventual formation of Conrail at an expense to the taxpayers of somewhere in the range of $7 to $10 billion.

The Staggers Act changed all this. It would surely be a tragic mistake to roll the clock back.

The CURE bill, as our testimony explains in more detail, represents such a tragic mistake. It would impose substantial burdens on both carriers and the ICC, artificially holding down rates for certain commodities, such as coal, and forcing railroads to attempt to make up those losses by increasing rates or cutting service for many commodities.

In one recent case, the utility plaintiff argued that shippers of other goods—steel, consumer goods, paper, farm products—should pay more than $400 million extra so coal rates might come down.

The question I ask you is: Should an entire industry be reregulated, should thousands of shippers bear substantial additional cost, and should consumer prices be increased in order to accommodate the position of only a very small portion of shippers who claim they could be adversely affected.

Thank you for the opportunity to share my thoughts with you today.

[The statement and questions and answers follow:]

STATEMENT ON BEHALF OF THE COMMITTEE AGAINST REVISING STAGGERS

My name is Frank R. Breslin. I am Director of Transportation, Scott Paper Company, and I am appearing today on behalf of the Committee Against Revising Staggers ("C.A.R.S."). C.A.R.S. is an organization of over 400 shippers of all sizes, having grown by 25% since S. 676, the current"C.A.R.S." bill, was introduced. Our members range from Fortune 500 companies to small, family-owned enterprises. We have both captive and competitive shippers, and many members who confront both competitive and non-competitive shipping situations. I am providing a list of our members, which shows that they are headquartered in 42 states. Undoubtedly, every state contains facilities of one or more of our members.

C.A.R.S. members believe that the Staggers Rail Act of 1980 is an extremely successful piece of legislation. By allowing railroads to respond efficiently to transportation market forces, it has dramatically improved rail service and provided the vast majority of shippers with lowered and/or stabilized rail rates. Therefore, C.A.R.S. urges that no legislation revising the Staggers Act be enacted at this time. In particular, we believe the "rate reasonableness" provisions of Section 4 of S. 676 would cripple the ability of the railroads to set reasonable rates that reflect market forces, and thereby undo the substantial benefits that the Staggers Act has yielded over the past decade.

RAIL TRANSPORTATION IN THE PRE-STAGGERS ERA

In the 1970's, the nation's rail shippers had to contend with unreliable, unsafe service and rapidly escalating freight rates. The national railroad system was literally falling apart: forty-seven thousand miles of track were in dangerous condition and under slow orders, and deferred maintenance (not including Conrail) was estimated at $1-½ billion at the end of 1978. Congress was forced to spend some $6 billion of public tax money to restructure and repair major parts of the system in the East and Midwest. Much rail traffic was forced to divert to other modes.

This dismal situation could be attributed in large measure to an archaic system of regulation under the Interstate Commerce Act which prevented the railroads from setting rates that reflected and responded to competition. Rates were largely determined by the value of the commodity transported, with "high-valued" manufactured goods bearing the preponderant share of the railroad's heavy fixed costs. This was significant because rail service requires a relatively large amount of capital investment in structures and equipment; fixed costs represent approximately one-third of a railroad's total cost of service. However, even though such high-valued product traffic faced competition from motor carriers, a railroad could not, under the embedded rate structure of the regulatory regime then in place, attract and maintain this business by charging such customers smaller shares of its fixed costs than it charged other customers with less competitive traffic.

As a result, railroads lost much traffic to their motor carrier competitors. This led to revenue losses, deferred maintenance and rounds of general rate increases, which in turn diverted even more traffic to trucks and barges—thus producing more revenue shortfalls and further railroad deterioration.

IMPACT OF C.U.R.E. SECTION 4 ON RAILROAD RATEMAKING FREEDOM

The 4-R Act and the Staggers Act helped to break this vicious cycle of railroad decay by permitting rail carriers to respond flexibly to market forces by setting rates at levels that accurately reflect the demand for their services. This ratemaking freedom—the ability to institute "differential pricing" for varying kinds of services—is constrained by the fundamental requirement that rates so established meet statutory and I.C.C. standards of rate reasonableness. Under the present Interstate Commerce Act, as amended by the 4-R and Staggers Act, a rail rate can be challenged as unreasonably high by way of a complaint proceeding if there is an absence of effective competition for the traffic involved, and if the rate's revenue/variable cost ratio falls at or above the market dominance jurisdictional threshold set out at 49 U.S.C. § 10709(d)(2) (this ratio can range between 170 and 180 percent; it is currently set at 180 percent). The complaining shipper, in accordance with long-standing legal principles predating the Staggers and 4-R Acts, has the burden of proving that a market dominant railroad's rate is unreasonable.

The pricing flexibility afforded by the Stagger's 4-R Act reforms has promoted the resurgence of the railroads over the past decade. Both service and safety have substantially improved. For example, according to the Department of Transportation, between 1980 and 1985 the total number of rail accidents involving hazardous materials dropped almost in half—from 819 to 415. At the same time, the DOT also said that accidents with release of a hazardous material dropped from 119 in 1980 to 54 in 1985.

Now, however, a group composed mainly of utility and coal-producing interests is seeking to undo this highly successful legislative and regulatory framework of the Staggers Act. Section 4 of the C.U.R.E bill, far from merely "fine-tuning" Staggers, would change the Interstate Commerce Act relating to the assessment of rate reasonableness in the following major ways:

It would shift the traditional burden of proof in rate reasonableness proceedings from the complainant shipper to the defendant carrier, thus requiring the railroad to rebut conclusively all allegations that the complaining shipper wished to make part of its case. Conceivably, this would require the railroad to meet an evidentiary burden with regard to, among other matters, each and every one of the fifteen issues contained in the National Rail Transportation Policy, 49 U.S.C. § 10101a (as it would be amended by Section 5 of the C.U.R.E. bill);

Perhaps most significantly, it would require the I.C.C., in all rate cases involving non-recyclable commodities, to "consider and make affirmative findings" as to whether the carrier's "need" for revenue adequacy demands rates in excess of the 180 percent revenue/variable cost jurisdictional threshold; and

It would shift the burden of proof concerning the "Long-Cannon" factors (49 U.S.C. § 10707a(e)(2)(C)) from the shipper to the carrier and require the I.C.C. to make "affirmative findings" as to (1) the amount of the railroad's traffic being carried below variable cost; (2) the amount of traffic making only marginal contributions to fixed costs; and (3) whether one commodity is paying an "unreasonable share" of the carrier's overall revenues.

Shifting the burden of proof in complaint proceedings to the defendant carrier, coupled with the requirement that the I.C.C. make "affirmative findings" regarding the cost characteristic of the challenged movement and all other commodity movements, would effectively transform the 170–180 percent revenue/variable cost jurisdictional threshold into a ceiling on the railroad's ability to establish differential prices. If a defendant railroad cannot meet the burden of proof with regard to each of the criteria listed in Section 4 of the C.U.R.E. bill, including making the "Long-Cannon" demonstration that all of its rates contribute their "fair share" to cost recoupment, or if the I.C.C. cannot make the affirmative findings that would now be required, the railroad will have to lower its rates on such movements. The railroad will then be forced to attempt to seek recovery of its total fixed costs by raising rates on other, more competitive movements whose rates are less than 170–180 percent, and are thus immune from maximum rate reasonableness challenge.

The short-term consequence would be increased rail rates for the majority of shippers; the long-term results would include increased rates for all shippers, including "captive" ones, because competitive shippers that have less costly alternatives would leave the railroad. The cycles of deteriorating service and escalating rates reminiscent of the pre-Staggers era would then ensue. The C.U.R.E. proposals, in short, would affect the service and rates of all rail shippers in a profoundly detrimental manner.

Contrary to the coal and utility rhetoric, it is the ability of railroads under Staggers to attract and keep competitive traffic which is helping to cover the railroad's fixed costs. This in turn is helping to reduce and/or stabilize captive shipper rates. Once competitive rail traffic leaves the railroad due to higher rates or less reliable service, then captive shippers who do not have such flexibility will be burdened with a large share of the railroad's fixed costs, and therefore will pay higher rates. It is the competitive rail traffic that is keeping captive shipper rates down, not the other way around as is often asserted by C.U.R.E. supporters.

The interrelationship between rates of different commodities is dramatically illustrated by evidence presented by the complaining shipper in I.C.C. Docket No. 38783, *Omaha Public Power District* v. *Burlington Northern Railroad* ("O.P.P.D."), which showed that the defendant Burlington Northern Railroad's ("BN") average revenue/variable cost ratio (derived from 1983 Rail Form A cost data) for its coal traffic was 1.87. In the same proceeding, the BN stated that the revenue/variable cost ratio for its coal traffic was 1.71, and presented as well revenue/variable cost ratios for specific non-coal commodities (also based on 1983 Rail Form A costs). For example, steel products moved at a 1.47 revenue/variable cost ratio; paper at 1.35; consumer and miscellaneous goods at 1.24; and farm products at 1.08. The complaining utility in O.P.P.D. argued, with regard to the Long-Cannon criteria, that many BN shippers were not paying their "fair share" of the railroad's costs, and that those shippers' rates should be increased by a total of approximately $459 million. This is one railroad, in one case.

This revenue/cost data is somewhat outdated, especially in light of the increased competition the BN's Powder River Basin coal traffic has faced since other railroads have gained access to that region. Nevertheless, the rate disparity between the railroad's coal movements and, for instance, its farm products traffic demonstrates the significance of differential pricing for shippers in different competitive circumstances. The I.C.C.'s 1985 waybill figures for all railroads confirm these pricing interrelationships:

[IAmounts in percent]

Commodity	Average revenue to variable cost ratio	Percent traffic exceeding 180% of variable cost
Coal	144.1	20.1
Chemicals	157.7	43.7
Transportation equip	199.3	75.5
Food	108.3	15.1
Farm products	109.9	14.9
Paper and pulp	124.7	9.4
Lumber	103.7	5.0

[Amounts in percent]

Commodity	Average revenue to variable cost ratio	Percent traffic exceeding 180% of variable cost
All commodities	129.1	25.3

It is clear that most commodities are able to move at competitive rail rates due to differential pricing. By far the vast majority of rail traffic, approximately 75 percent, moves at rates below the 180 percent revenue/variable cost ratio, including most paper industry goods, manufactured products, food products, and other consumer goods. In fact, about 80 percent of coal—the self-proclaimed "captive" commodity which is the principal focus of the C.U.R.E. effort—moves at less than 180 percent of variable cost. Section 4 of the C.U.R.E. bill would arbitrarily and artificially attempt to redistribute rate burdens in such a way that the vast majority of commodities, including most coal movements, would be forced to assume costs that the market would otherwise allocate to other, less competitive commodities and routes.

LONG-TERM IMPACT OF C.U.R.E. SECTION 4

In the long run, railroad efforts to raise rates on competitive traffic will have adverse effects. Those shippers with competitive transportation options will desert the rail carrier who is compelled by regulations to raise its rates above a competitive level. As a result the carrier, in order to remain solvent, must eventually attempt to recover a greater percentage of its fixed costs from the smaller base of less competitive traffic. Further losses of competitive traffic will occur. Overall carrier revenues would decline and service (as well as safety) would likely deteriorate. Railroads *and* shippers would once again confront pre-Staggers Act conditions, with the prospects of government and public subsidization of weak railroads, traffic losses, deferred maintenance, and lessened safety. Thus, market-distorting regulation that thwarts differential pricing assures that "captive" shippers, and the consumers of their products, will suffer the effects of higher rates and poor service.

CONCLUSION

Today's hearings are on the same basic subject as the legislative discussions in 1979 and 1980 that led to enactment of the Staggers Act. The question being asked then was what is the best way to allocate the large fixed costs of the railroads among thousands of individual movements? The traditional method of value-based ratemaking had been destroyed by the motor carriers and the interstate highway system. The available alternative methods appeared to be based upon demand or upon cost. Superficially, a cost-based allocation, with each movement paying a uniform percentage over the variable costs, would seem to be the fairest. However, cost-based ratemaking would divert substantial rail traffic to motor carriers and eventually result in a skeletal rail system hauling only bulk commodities long distances over a few dense corridors.

A demand-based system seemd to have the best chance of maximizing the total traffic over which the fixed costs could be spread, thus in the long-run minimizing the per capita contributions of all shippers while providing sufficient cash flow for the railroads to maintain their track and equipment so that good service could be provided. The Staggers Act embraced such a system and it works. The C.U.R.E. bill, by contrast, relies on the allocation of fixed costs according to variable costs—an approach which will shrink rail traffic, starve the railroads of the funds needed to maintain service, and eventually hurt all rail users.

Adoption of a demand-based system, under Staggers, also led to a somewhat unexpected benefit. By forcing the railroads to respond on demand, it stimulated the emergence of railroad marketing. This new focus on the shipper and his needs has been revolutionary, and has resulted in tremendous rate, service, and safety improvements. A return to an adversarial, highly-regulated, cost-based environment will destroy much of this new system which has been so beneficial to all parties.

Section 4 of the C.U.R.E. bill, by hampering the ability of railroads to set reasonable rates that reflect market forces, would raise the transportation costs borne by virtually all consumers and would eventually work to raise rates and compromise service for all rail shippers. We urge this Subcommittee to reject the short-sighted effort of a narrow group of coal and utility interests to undo the benefits that the Act has provided for the vast majority of your constitutents.

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS

Question 1. Burden of Proof.

Answer. Complaining shippers have always borne the burden of proof in rate reasonableness complaint proceedings. This burden is a feature of the Interstate Commerce Act that predates both the 4-R Act and the Staggers Rail Act. Complainants typically have the burden of proof in Federal administrative proceedings. The discovery procedures of Interstate Commerce Commission should provide ample and fair opportunity for complainants to obtain the relevant information necessary to develop their cases.

In addition, the bill also requires the Interstate Commerce Commission to make affirmative findings with respect to the Long-Cannon factors, i.e., the amount of the railroad's traffic being carried below variable cost; the amount of traffic making only marginal contributions to fixed costs; and whether one commodity is paying an "unreasonable share" of the carrier's overall revenues. To enable the Commission to make these findings, the railroad is given the impossible task of proving that each one of its rates is reasonable in order to prove that any one rate is reasonable in terms of the Long-Cannon factors.

Question 2. Rate Increases.

Answer. Section 4 of the C.U.R.E. bill will have the *immediate* effect of raising rates in the short term on competitive traffic, since the railroad will be forced to lower rates on higher priced commodities. Many shippers, particularly smaller shippers, whose goods could theoretically move by another mode, do not have the flexibility in the short run to shift to such other modes and would have to absorb a rate increase to make up for the railroad revenues lost when rates are forced down on higher priced commodities.

The interrelationships between rates of different commodities is dramatically illustrated by evidence presented by the complaining shipper in Docket No. 38783, *Omaha Public Power District* v. *Burlington Northern Railroad* ("O.P.P.D."). In that proceeding, the BN stated that the revenue/variable cost ratio for its coal traffic was 1.71, and that steel products moved at a 1.47 revenue/variable cost ratio; paper at 1.35; consumer and miscellaneous goods at 1.24; and farm products at 1.08. The complaining utility in O.P.P.D. argued, with regard to the Long-Cannon criteria, that many BN shippers were not paying their "fair share" of the railroad's costs, and that those shippers' rates need to be increased by a total of approximately $459 million!

In the long term, as reflected by the statements in the hearings, there will be loss of some amount of competitive traffic, diminishing the railroad's traffic base, and thus forcing the railroad in the longer run to try to recover more of its fixed overhead costs from less competitive traffic by increasing its rates on that traffic. These increased rates for such traffic would not stop with the railroads' as rail rates float higher, competing modes will tend to push their rates up to the extent they can without losing any advantages. the results of this upward spiral caused by H.R. 1393's attack on differential pricing will be rate increases for shippers, no matter which mode they chose.

The railroad will find itself stuck "between a rock and a hard place"—faced with the no-win choice of attempting further increases in competitive traffic rates versus attempting to extract ever greater amounts of fixed costs from non-competitive traffic. Under these circumstances, the railroad will likely defer maintenance and take other steps to reduce its overhead costs, thus setting in motion once more the pre-Staggers "vicious cycle" of deteriorating service and safety. It is precisely because the railroads cannot in the long run increase rates beyond a certain point without loss of competitive traffic—the fundamental market fact which C.U.R.E. seeks to interfere with—that railroads would eventually be left with a shrunken traffice base paying relatively high rates.

Question 3. Competitive Access.

Answer. C.A.R.S. currently has no position with regard to competitive access legislative proposals. Its testimony has focused only upon the impact of the rate regulation of the C.U.R.E. bill upon railroad differential pricing.

Senator EXON. Thanks for your testimony. Let me answer your question, Mr. Breslin. My answer is a definite yes, if the Federal regulation that has been created is unfairly and adversely affecting certain people that have no other recourse.

I know and realize that there are people who say, don't worry about some of these people. They will prevail, or they will go out of business, and the common good is what we are most interested in.

I can only speak for one Senator, and I have not decided for certain how I will come down on this issue if it comes to a vote in this subcommittee, in the full committee, and on the Floor.

But I believe that I share the feeling of most of my colleagues, that when we created the Staggers Act, we thought that we provided properly for captive shippers. That may not be very important to a great big paper company in Pennsylvania, but I assure you, it is of keen interest to those of us who represent some smaller States where there are captive shippers.

Now having said that, I have said before when you were not here, that as far as most of my constituents are concerned, the Staggers Act has proven beneficial.

I would certainly agree with you that overall, we have done the right thing, and it has been good for both the shippers and the rail industry.

I guess the only thing that I would caution you on is that there remains concerns for certain captive shippers. And we are seeking reasonable ways to address that.

Whether or not CURE is the way to do it, I do not know. But I do know that there remains a concern on this subcommittee, and the Commerce Committee as a whole, in trying to protect as best we can, what we intended to do when the Staggers Act was passed.

I have a couple of questions, and then I will turn it over to Senator Rockefeller.

Mr. **Breslin**. Could I comment on your comment?

Senator **Exon**. You certainly can, Mr. Breslin.

Mr. **Breslin**. I did not mean to communicate in anyway that we had a less concern for the small shipper. In fact, 60 percent of the members of CARS are small shippers. And we have great concern.

So if I communicated the essence of something different than that, then I did not communicate very well.

In fact, I would like to leave with the committee today testimony from many, many small shippers, probably aligned like many that you have identified, but who are also members of CARS.

Senator **Exon**. Your statement was accepted for the record. We were glad to accept it.

I took it from your statement and your conclusion, and maybe it is—did you read from that statement in your conclusion of your nonprepared remarks?

Mr. **Breslin**. I do not understand your question, Mr. Chairman?

Senator **Exon**. I just listened to your testimony; maybe I heard it wrong.

The final part of your statement, did it not indicate that basically everything was working so well that no changes were necessary in any way, shape or form; was that not the thrust?

Would you read it again please? Maybe I misinterpreted it.

Mr. **Breslin**. I can read it.

Senator **Exon**. Please read it, because that is in the record already, and if there is a mistake I want it corrected.

Mr. **Breslin**. You just want the last portion?

Senator **Exon**. Well, I want the last portion wherein you got into the matter, you said, let me ask you a question. Go from there on down.

You asked me a question and I was attempting to respond as best I could.

Mr. **Breslin**. Thank you.

The question I ask you is: Should an entire industry be reregulated? Should thousands of shippers bear substantial additional costs? And should consumer prices be increased in order to accommodate the position of only a very small portion of shippers who claim they could be—and I underlined could be—adversely affected.

Senator **Exon**. Could be. Are you maintaining they are not?

Mr. **Breslin**. Since I do not have the facts as to who those shippers are, and what the facts would be surrounding them, it would be subjective for me to comment about that.

Senator **Exon**. Thank you, Mr. Breslin. That helps to clarify it somewhat.

I still feel that the statement that I made with regard to concern to captive shippers permeates this committee on both sides of the aisle. But we appreciate your views.

Mr. Disbrow, let me ask this question. Did not the ICC action with regard to the Omaha Public Power District partially solve the problem of the industry that you represent?

It certainly was a step in the right direction to show some concern, was it not?

Mr. **Disbrow**. It might appear that way. But as I understand it, that decision is not precedent setting, number one. And number two, they are talking about adopting that, if they do, for only small coal producers.

Clearly our company is not a small coal purchaser. So we would still face the Mt. Olympus of regulation in trying to prove stand-alone costing.

I might just indicate what that would mean from an electric utility point of view, because that is what I am most familiar with.

If we were to try to judge our rate structure today against stand-alone costing as practiced by the ICC, we would take our $15 billion corporation and translate it into something between $80 and $100 billion. Clearly we would be revenue inadequate.

Senator **Exon**. I have one question of you, Mr. Zitto, because I listened to yours and all the testimony very carefully.

In your view, is it not true that the ICC, after essentially ignoring captive shippers for the first several years under Staggers, have not they seemingly come around somewhat to discharging their responsibilities as to captive shippers in the manner that most of us viewed their responsibilities when Staggers was passed?

Has there been any improvement in the ICC's actions with regard to captive shippers? Or do you see it continuing essentially as it has been in the earlier years under Staggers?

Mr. **Zitto**. Senator, I do not see any improvement. There have been a few decisions that have come down on the side of shippers. They always seem to come down just before there is to be a congressional hearing.

But on the very basic issues, the furtherance of competition among railroads, their position has not changed.

The landmark case in this whole area is the Midtec case, where the Commission finally made a decision that requires, before you can get access to another railroad, to show all the classic requirements of an antitrust case: a price squeeze; a refusal to deal. And that is an intolerable burden.

Now the Midtec decision is going to be the case that is going to be used in determining competitive access, reciprocal switching. They have not changed one iota.

I certainly do not share Mr. Riley's optimism about how there are so few cases, so few protests. I guess I am handicapped by having worked for railroads for 10 years and worked for shippers for 20 years in negotiating with railroads.

But the reason there are not more cases pending, is the perception of the shipper that it would be absolutely futile, and an insane act, to waste your time filing with the Interstate Commerce Commission.

Senator EXON. One last question, and I will ask this of you, Mr. Zitto, and you, Mr. Disbrow, because your testimony has been on one side of this issue. In about 18 months we are going to have a new administration. No one knows who will win the presidential election two years from now, but we are going to have a change in administration.

With that change in administration, very likely is to come changes in the structure of the ICC and the regulatory agencies that now have a hand in this matter of the Staggers Act.

If we have a change in administration, would you say that there is a better than a 50–50 chance that the changes would be made so that the captive shippers would be better treated than they have under this Administration and under its administration of the ICC and the regulatory usage of the Federal government?

Or, following up on that, if we do not do anything at all with regard to changing the Staggers Act now, there is an optimistic chance, is there not, that a change in the people that administer the Staggers Act would make it more in compliance with the way you think it should be interpreted?

Mr. DISBROW. Well, Senator, that may well happen, but we do not think we can rely upon a change in administrations or a change in appointees to the ICC to protect captive shippers. We believe there needs to be more definition and a more realistic definition and a more realistic discussion before the ICC, as to how they should pursue captive shipper complaints.

Senator EXON. Mr. Zitto.

Mr. ZITTO. I agree completely with what Mr. Disbrow has said. We simply cannot take our chance on the caliber of political appointments to the Interstate Commerce Commission in the future.

To give you a specific example, as part of the Staggers Act they did provide the requirement for reciprocal switching. There was a plank put in that would encourage reciprocal switching as a procompetitive condition that would help replace regulation.

Well, the final wording of the Interstate Commerce Act did not make it mandatory. They simply made it "may provide reciprocal switching." It seems to us that there has to be more definition to narrow the discretion of future Commissions so that they at least come down on the side of competition whenever there is a possibility.

We are not optimistic about depending on individual appointments to the Commission in the future.

Senator **Exon**. Well, we are talking about basically how far the Congress goes. The people of the United States elect the President of the United States to carry out a whole broad range of policies, and I for one have been somewhat reluctant for the Congress to micromanage everything that happens in our defense industry on the Armed Services Committee upon which I serve, and to micromanage too much of the laws that we pass.

Let me try and get a sense of this by asking this last question, if you will be patient just for a moment, Senator Rockefeller, as you usually are. When the Staggers Act was passed, did either of you, Mr. Zitto or Mr. Disbrow, feel that we were allowing too much leeway to the ICC at that time, as you think we have at this juncture?

Mr. **Disbrow**. I do not necessarily think that there was too much latitude at the time of the enactment of Staggers. However, the implementation of it has certainly indicated that there is very wide discretion. We are not asking Congress to come down with a very detailed prescription of how it is to be done, but just simply to put in place broad but reasonable guidelines as to how captive shipper complaints are to be resolved.

And there have been some who have said, as you might have implied a little earlier, be patient, things will change. Well, we have been patient for seven years and nothing has changed.

Senator **Exon**. Seven years under the same administration.

Mr. **Zitto**. I agree with that. I did not at the time feel that the Congress was giving too great discretion to the Interstate Commerce Commission. I was optimistic at the time—the Staggers Act was a result of a series of compromises between shippers, railroads, and the legislative process—that it would work.

And it is our opinion that if the Interstate Commerce Commission had followed the will of Congress and interpreted the statute as it was intended, there would be no problem. But that has not taken place.

Those provisions that were put in as pro-competitive provisions to encourage competition, the Commission absolutely turned their back on. We did not visualize that would happen at the time.

Senator **Exon**. Thank you very much, gentlemen.

Senator Rockefeller.

Senator **Rockefeller**. Mr. Chairman, I just want to say to you that in this, our last hearing, I think that you, as you always are, have been extraordinary in your patience and in your willingness to spend time on this and in your open-mindedness.

You conduct a fair, tough, good hearing, and I want to tell you that I am very grateful, very grateful to you.

Senator **Exon**. Thank you.

Senator **Rockefeller**. Mr. Dempsey, if I might, sir, you imply on page 7 in your footnote that basically all traffic plays by the same rules.

Mr. **Dempsey**. Page 7?

Senator ROCKEFELLER. Yes.

Mr. DEMPSEY. Of my full statement? I do not find it.

Senator ROCKEFELLER. Your summary statement, the last paragraph.

Is it not the case that Congress assumed that traffic below 180 percent revenue to variable cost would be protected by competitive forces on the one hand, while traffic above the 180 percent threshold would be protected from any excess by the ICC?

Mr. DEMPSEY. The first part is correct. The second part is, if modified by the finding of market dominance or lack of effective competition. In other words, there is no assumption that above 180 percent the shipper is captive under Staggers.

Senator ROCKEFELLER. Understood, all right. In fact, the Long-Cannon amendment, was it not, was specifically included in the law to assure that traffic between 100 and 180 percent revenue to variable cost was paying the most that the competition would allow, so that the cost would not be loaded up on captive shippers, is that not correct?

Mr. DEMPSEY. Correct.

Senator ROCKEFELLER. Have you not said that railroads—that the railroad must charge 152 percent revenue to variable cost on average to be revenue adequate?

Mr. DEMPSEY. Yes.

Senator ROCKEFELLER. Now, you have also said that piggyback traffic pays only 112 percent, am I correct?

Mr. DEMPSEY. That is my best recollection, but it is around there.

Senator ROCKEFELLER. Do you contend that any of this traffic is contributing to profit?

Mr. DEMPSEY. Surely, 12 percent. I do not mean 12 percent of profit, but that 12 percent contributes to profit.

Senator ROCKEFELLER. Not overhead but profit?

Mr. DEMPSEY. Profit. Well, it discharges the—you can go at it either way. You've got to discharge your fixed costs which include a return on capital or "profit". Whether you say that the piggyback 12 percent goes to profit or whether it goes to overhead and the rest goes to profit, it does not matter.

It is all part of the profit picture.

Senator ROCKEFELLER. Let me try it another way. What would happen if all of your traffic were priced at 112 percent?

Mr. DEMPSEY. We would go into bankruptcy as rapidly as we could get to the court.

Senator ROCKEFELLER. Now, based upon this exchange, I think it is fair to comment that it is misleading to hear statements about how much the traffic between 100 and 130 percent revenue to variable cost contributes to profits. You would not, I take it, agree with me?

Mr. DEMPSEY. I would not agree with you, that is correct.

Senator ROCKEFELLER. On the McCarty case which we discussed the last time, you indicated that you had not yet had a chance to review that. Have you had a chance to review it?

Mr. DEMPSEY. I have, Senator, yes.

Senator ROCKEFELLER. Do you agree with the rate reasonableness test applied by the ICC in that case?

Mr. DEMPSEY. I do not.

Senator ROCKEFELLER. You do not. Do you think that it makes sense to have different rate reasonableness tests for different commodities?

Mr. DEMPSEY. I do not know the answer to that, Senator. It is not in my field of expertise. But let me, if I may, just indicate what two of the things are fundamentally flawed in the McCarty Farms test.

In the first place, the Commission asserted that it was averaging all like traffic, that the market conditions were the same or substantially the same with respect to all the traffic that it was looking at, and they were all captive shipments.

Well, that clearly is not the case when you just throw everything over 180 percent in that category, number one.

Number two, if it is extended then obviously the averages keep going down.

Number three and perhaps most interesting, it seems to me that the logic really ought to go the other way. Applying the Long-Cannon factors, rates ought to be driven to the highest level because the Commission is asserting that the market conditions on all these movements are the same. Well, if that is the case—and let me assume that the highest was 250 percent and the lowest 200 percent—presumably the railroads could charge the 250 percent for all the rates presently below the 250 percent level. That ought to be the result logically.

Now, that is a lot of nonsense, but it is a lot of nonsense because the market conditions are not the same.

Senator ROCKEFELLER. Thank you. Mr. Dempsey, when a railroad sets a rate, does it have to obtain prior approval from the ICC or may it put the rate into effect immediately without any regulatory agency review?

Mr. DEMPSEY. No, it does not have to obtain prior approval, but if there is a protest, the Commission may suspend and investigate the rate.

Senator ROCKEFELLER. Otherwise the railroad can go right ahead and apply the rate?

Mr. DEMPSEY. That is certainly my understanding.

Senator ROCKEFELLER. Now, when the railroad quotes a rate to a captive shipper, does the railroad tell the shipper what the revenue to variable cost ratio is?

Mr. DEMPSEY. I am not in the marketing of railroad services, Senator. I just do not know. I do not suppose that they would.

Senator ROCKEFELLER. You have been around railroads for a while. In other words, you tell them what it is going to cost them per ton?

Mr. DEMPSEY. Yes.

Senator ROCKEFELLER. But in terms of the revenue to variable cost ratio, which is pretty crucial, does the railroad make that information available to the shipper?

Mr. DEMPSEY. I would just have to guess, probably not, because I do not know. It just does not sound to me like something that in your normal business you do, railroad or otherwise.

Senator ROCKEFELLER. How might the shipper be able to find out something that is so important as that rate ratio?

Mr. DEMPSEY. Mr. J. Thomas Tidd, our Vice President of Law, would answer this.

Mr. TIDD. I would say if they are a sophisticated customer, like American Electric Power which is shipping millions of tons of coal, they have experts who can determine railroad costs fairly precisely, and I am assuming they do that all the time.

Senator ROCKEFELLER. Not only sophisticated, but quite large.

Mr. Disbrow, how much would that cost you and how much time?

Mr. DISBROW. We indeed employ a consultant, and it is around $10,000 for each inquiry.

Senator ROCKEFELLER. To find out a single——

Mr. DISBROW. His best estimate, which is not beyond argument, but his best estimate of the variable cost to the tariff rate.

Senator ROCKEFELLER. Mr. Dempsey, a couple of questions about ICC actions, Mr. Chairman, and then I will wind right down, as I always do.

Have not the railroads appealed the changes in the revenue adequacy test?

Mr. DEMPSEY. Yes.

Senator ROCKEFELLER. Have not the railroads appealed the changes in the rail inflation index, the rail cost adjustment factor?

Mr. DEMPSEY. The AAR has not. Conrail has appealed it.

Senator ROCKEFELLER. And is Conrail not continuing that appeal?

Mr. DEMPSEY. Well, so far as I know. I have not inquired.

Senator ROCKEFELLER. I believe they are.

Have not the railroads that have lost those cases, rate cases at the ICC, appealed?

Mr. DEMPSEY. I assume so. Again, not out of personal knowledge, but it is just what I would expect them to do so. You are talking about Omaha and Arkansas Power & Light?

Senator ROCKEFELLER. Yes.

Mr. DEMPSEY. I am sure they have appealed. Unless their deadline has not come yet, they have appealed.

Senator ROCKEFELLER. For McCarty Farms and Arkansas Power & Light, do you expect the railroad to appeal if those decisions stand?

Mr. DEMPSEY. I believe that, subject to correction by the record, that Mr. Gaskins, the President of the Burlington, said that if McCarty Farms came out that way they would appeal. That is my recollection of his testimony.

Senator ROCKEFELLER. That was mine also.

Is it not fair to say that the jury is still out, then, in terms of ICC rate reasonableness tests and others?

Mr. DEMPSEY. I certainly hope so.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Senator EXON. Thank you very much, Senator Rockefeller.

Senator ROCKEFELLER. Mr. Chairman, I have a number of other questions. I have about 10 or 15 other questions which I will submit for the record and hope that the witnesses would reply as quickly as possible.

Senator EXON. Senator Rockefeller, we appreciate that and I am sure the witnesses do also. If you would please reply as promptly as possible to the very important questions that will be posed to you.

In concluding these hearings, let me thank you five gentlemen for coming and giving us your expertise in this area. Let me thank

Senator Rockefeller for bringing this up because I think, if nothing else has been proven by these hearings that we have had, we have some potential problems in this area.

And regardless of what happens to this bill that Senator Rockefeller has properly introduced, which caused these hearings to be held, I think it has been made very clear to the ICC that the Congress is not totally happy with the job that they have been doing in administering the Staggers Act.

Indeed, I think the hearings have proven beyond any question of a doubt that the ICC becomes concerned about the captive shippers only when some pressure comes from the Congress of the United States.

So I thank all of you for coming. I thank the witnesses that appeared previously. I appreciate the generally good attendance that we have had from the subcommittee. And we will at a subsequent time take up what disposition will be made of the CURE bill.

With that, we thank you and we are adjourned.

[Whereupon, at 12:25 p.m., the subcommittee was adjourned.]

ADDITIONAL ARTICLES, LETTERS, AND STATEMENTS

STATEMENT OF MICHAEL BURRILL, PRESIDENT, SISKIYOU SHIPPERS ASSOCIATION

Mr. Chairman and Members of the Committee: My name is Michael Burrill. I am President of the Siskiyou Shippers Association which represents several forest product manufactures located in Oregon. I am pleased to have the opportunity to present to you the views of the Siskiyou Shippers Association on the implementation of the Staggers Act by the Interstate Commerce Commission. Members of my Association are primarily smaller companies to whom the issue of the cost of transportation can be the critical difference necessary for long-term survival in our highly competitive industry.

I would like to highlight for the Committee one area in which two recent decisions of the ICC have combined to create significant problems for small shippers of forest products. These decisions, when considered in conjunction with other events in the marketplace, raise serious questions about how well competition is working or can work under the ICC's implementation of the Staggers Act.

First, however, let me explain that the members of our Association are almost entirely dependent on railroads for the shipment of our products. Almost all of our products are shipped by rail. In particular, our members primarily use boxcars for the shipment of their products. We are all captive shippers on the Siskiyou line of the Southern Pacific. As captive rail shippers, ICC decisions under the Staggers Act become extremely important to us.

One of the provisions of the Staggers Act made it easier for shippers and carriers to negotiate rates and services, rather than to have to rely on published tariffs. In this way rates were to reflect efficiencies made possible by larger volume shipments and other arrangements between carriers and shippers. The negotiation of rates and services was intended to bring the benefits of a more competitive marketplace to rail transportation.

However, the authors of the Staggers Act also realized that shippers do not always have truly competitive alternatives to rail transportation. Some industries, such as ours, are heavily dependent on rail transportation, reducing our ability to bargain freely and fairly with the railroads and increasing the carriers' ability to exert significant pressure on our operations by virtue of the lack of competitive alternatives available to us.

For that reason, the contract provisions of the Staggers Act mandate a certain degree of public disclosure of the essential terms of negotiated contracts. Disclosure of these terms is absolutely essential. Without disclosure, contracts involving common carriers can lead to destructive competition, in total contradiction of our public policies governing common carrier obligations and fair and effective competition. For us, it can mean an inability to market our products in what were traditional market areas because of unjustified inequaties in transportation costs between us and our competitors.

In drafting the provisions of the Staggers Act, Congress tried to design a careful balance between deregulation and fair treatment for those who are dependent on railroads for transporting their products. Competition was to be encouraged, but not at the expense of small businesses. Congress did not want negotiated rates and services to become the weapon used by big shippers to force their smaller competitors out of the market.

By 1986, when Congress was debating the Conrail Privatization Act, it had become clear that the balance between the freedom to contract and the need for reasonable disclosure needed to be adjusted in favor of greater disclosure for certain rail-dependent commodities. Congress directed the ICC to revise its rules for disclosure of contract terms relating to agricultural contracts. In the course of its review of contract disclosure requirements for agricultural contracts, the Commission decided that some modest, but important, changes in other disclosure requirements were also required.

On December 23, 1986, the ICC adopted new interim rules governing disclosure requirements for (1) agriculture commodities; (2) forest products and paper; (3) port traffic (other than agricultural commodities, forest products and paper); and (4) other commodities or services not involving a port. The interim rules also established new informal discovery procedures that would be available to many shippers, including shippers of forest products.

As noted by the Commission at the time the interim rules were published, the new disclosure requirements were necessitated by the Conrail Privatization Act and by the ICC's experience with the prior interim rules governing disclosure. Experience had shown that some new information and some more specific information was needed to help assure that competition remained free and open, and that similarly situated shippers are not discriminated against by unjustified inequality in rates and services.

Since our industry is so highly dependent on rail shipping, the Committee might be expected to assume that we would be highly supportive of the Commission's interim rules. As a matter of principle, we would like to see if these rules will benefit our industry. Unfortunately, because of another Commission decision, we cannot benefit from the Commission's interim rules, even though our industry is one that requires a reasonable balance between the freedom to contract and the disclosure of contract terms.

In January 1984, using its exemption authority under the Staggers Act, the Commission deregulated the shipment of commodities by boxcars. Members of the Siskiyou Shippers Association ship largely by boxcar. Since ICC rules, including contract disclosure requirements, no longer apply to shipments by boxcar, we cannot benefit from the new, interim disclosure rules. To the extent deregulation of flatcars is similarly pursued, our benefits from the disclosure rules would be completely eliminated since shipments not sent by boxcar are sent by flatcar. We see no reason in policy or law why deregulation of a certain car type should also automatically sweep aside the rules relating to contract disclosure.

Let me assure the Committee that we are not advocating a return to pre-Staggers regulation of rates and services. On the contrary, we continue to be supportive of this change in public policy. Deregulation has brought the benefits of a competitive marketplace to the industry and to consumers of forest products. However, the benefits of a competitive marketplace are predicated upon reasonable availability of information. Without sufficient information, a competitive marketplace cannot operate. Here we are being denied information for no good reason.

Historically, small shippers have been unable to negotiate contracts from railroads. We simply did not have the volume of commodities needed to bargain on a fair and equal basis

Recently our members have tried to overcome this disadvantage by offering to aggregate shipments in order to receive contract rates and services. Since the aggregated volume would be equal to the volume offered by larger shippers, the rationale for a contract rate should be fulfilled. But even when we offer to aggregate our shipments, the rail carrier serving us will not give us contract rates. Our offers to take other steps to make our members and their shipments equal in status with big shippers have met with a similar unwillingness on the part of this carrier.

We are left with no option but to conclude that our rates are being unfairly maintained at unwarranted levels, while big shippers are benefiting from contract rates and services. But we cannot even begin to pursue any recourse without information on the rates and services being provided to big shippers. Even the most limited information provided in the Commission's contract summaries is denied to us simply because we ship on one particular type of rail car. The fact that we ship on boxcars has nothing to do with our unequal bargaining position with the carriers. Our problem is related to our size, our dependence on rail transportation, and the unwillingness of carriers to treat our aggregated shipments in the manner that they would treat bigger shipments—and these problems do not go away just because we ship on boxcars.

In 1980, Congress made the determination that some balancing of contract rates and disclosure of information is necessary in order to preserve fair and equal competition in rail transportation. Our industry is dependent on rail service. Truck transportation does not provide effective competitive restraint on rates charged by railroads for the shipment of our products, nor can we shift to other types of railroad cars to provide that restraint. We are highly dependent on a particular segment of the transportation market being truly competitive.

If small shippers cannot obtain rates and services that are competitive with large shippers, we are effectively closed out of many of our markets. We cannot ship our products in a cost-effective manner from the Northwest into East Coast and Midwest markets, Southern California or Texas. If the longer haul markets are closed to us because of excess transportation costs, we suffer irreparable harm and consumers in those regions are deprived of effective competition, precisely the result that Congress was trying to avoid when it authorized more competition in the rail industry. Big shippers are able to push their competition out of the market because the Commission no longer applies contract disclosure rules to shipments by boxcars.

The contract disclosure rules were adopted to preserve competition. We do not know if the Commission's current interim rules governing forest products would be the entire answer for our concerns, but we would like the opportunity to try them.

Disclosure requirements for forest products would cause the least interference in a deregulated market necessary to preserve fair competition for those shippers who have no practical alternative to shipment by rail. We do not believe it is inconsistent with deregulation to provide rail-dependent shippers with enough information to be able to pursue possible abuses of market power.

Indeed, we might suggest to the Committee that the Commission cannot fulfill its affirmative duty to review carrier actions after the fact in order to correct abuses of market power without such minimal information.

The Staggers Act clearly intended to encourage the Commission to take whatever steps were needed to reduce unnecessary federal regulation of rail services. Federal regulation was not to be retained on the basis of mere "possibilities". But Congress was equally clear that a decision by the Commission to use its exemption authority to deregulate segments of the rail transportation market was not to be the end of the Commission's responsibilities. The conferees were very explicit when they stated that "[t]he conferees expect that as many as possible fo the Commission's restrictions on changes in prices and services by rail carriers will be removed and that the Commission will adopt a policy of reviewing carrier actions after the fact to correct abuses of market power." Assessment of market behavior to prevent abuses of market power was to remain a responsibility of the Commission.

There may be several ways in which to address the problems we have identified, and we would be happy to discuss possible solutions with the Committee staff. At a minimum, however, Congress should urge the Commission to reasssess the exclusion of shipments in boxcars or any other deregulated car type, from its contract disclosure rules.

The Staggers Act has brought many benefits to the transportation industry. It was a bold and innovative piece of legislation, but it was never intended to be the final solution. Congress envisioned an evolving process, one that would constantly reassess market conditions and refine provisions of the Staggers Act when necessary. We believe that for small shippers of forest products, it is time for that reassessment.

Thank you for the opportunity to present these views.

STATEMENT OF TED DELZER, PRESIDENT, THE RAIL ACTION CORPORATION [TRAC]

Mr. Chairman, members of the subcommittee. I appreciate the opportunity to discuss with you a topic that is very important to all of us and rural America. For this reason, I am submitting written testimony to the subcommittee on S. 676.

Mr. Chairman, members of the committee: The Rail Action Corporation (TRAC) is a nonprofit organization that was formed and is committed to preserving rail service from Moorhead, Minnesota to St. Cloud, Minnesota. This type of line is commonly referred to as a short line.

In addition to being president of TRAC, I am also president and part owner of "Dalton AG Service", a grain facility in Dalton, Minnesota. Dalton AG Service relies upon the railroad line described above.

TRAC is committed to preserving and maintaining this line, whether under BN ownership or under a new short line ownership. We have offered our time and services to the line's new management in an effort to ensure that there remains viable railroad service. This past year has provided TRAC with first hand knowledge of the issues and problems facing this line. Some of the problems are avoidable and have eroded the confidence of shippers and hampered our efforts to promote traffic on this line.

The northern half of the line lies in the Red River Valley which includes some of the richest farm land in the State. There are millions of bushels of grain in Government and on-farm storage in this area.

The southern section is more diversified with dairy, turkeys, corn, beans and wheat. This area has enormous amounts of grain in Government and on-farm storage. This grain will ultimately be shipped along with new crop.

THE FOLLOWING BEST DESCRIBES TRAC'S POSITION

TRAC supports the concept of short line railroads taking over the operation of lines that have proven not to be economically viable under the management of the dominant carriers such as Burlington Northern, where local management has the potential to operate profitably and provide needed service. We feel this concept can benefit shippers if the sale is to a reputable and capable short line operator willing and able to provide good service at competitive rates. However, we believe that under ICC implementation the Staggers Act has serious shortcomings and does not adequately protect shippers' interests, especially where the ICC exempts the sale from notice and hearing requirements. We support legislation to make changes to protect shipper interests.

The wholesale granting of exemptions to hearing and other procedural requirements is allowing these sales to take place without an adequate examination of the public interest.

Expedited, no-hearing exemptions deny shippers the opportunity to have any input into the question of a sale of a branch line. Conditions may be included in such an unexamined transaction which will artificially limit service and revenues and bring about abandonment.

Recently the Burlington Northern sold to the Otter Tail Valley Railroad (Short Line) a portion of what had been a main, or through service line. By selling the section of the St. Paul to Moorhead Line which runs from Dilworth to St. Joseph, and disconnecting the track between St. Joseph and St. Cloud (by the removal of a section of rail) the Burlington artificially created a segment that is intended for abandonment. That segment is the line from St. Joseph northwest to Alexandria or Fergus Falls. At the same time the BN kept for itself the coal traffic and revenues at St. Joseph, and it kept control over all other existing traffic, rates and revenues on the line. It appears that it also kept most incidents of ownership, including the rights to all revenue from use of the real estate under the line. By denying the short line operator the right to use the line between St. Joseph and St. Cloud it also has apparently denied meaningful competition to shippers on the line. The OTVR is a captive handmaid of the BN.

The availability of competition and open ended terminus points on the line appear to be, from our investigation, crucial requirements of viable short line operations. The OTVR Railroad is a new company formed for the purpose of this sale of railroad operations. The ICC issued an exemption from the rules and the sale was consummated without any hearing or notice to shippers (other than the Federal Register notice which is hardly calculated to attract the attention of rural shippers.)

The fear of imminent abandonment which this sale has created is a difficult obstacle preventing expansion of rail-dependent businesses on the southern part of this line. Instead of being able to maximize the potential for traffic on the line, the peculiar structuring of the Sale Acts to minimize it. If the sale had been structured to include an open-ended terminus in St. Cloud, permitting of competition, and of routing south bound traffic directly south (instead of north through Dilworth), and providing the coal revenues from the St. John's traffic to the short line, this operation would be extremely viable and shippers would be confident of the future and putting their money into expanding their operations. As it is, the situation appears destined, by intent, for abandonment.

The Burlington Northern sets the rates: The BN owns the cars and holds the leases and permits on all property on the railroad right of way. In short, they continue to control and dominate short line rail operations. If the BN fails to cooperate with a short line operator and furnish cars as needed, or establish competitive rates, it can make or break a short line operator and set up any segment of a short line railroad as a target for abandonment.

What we are seeing is not an emergence of new competition in railroading, it is just one more novel form of control by the dominant carriers. The attention of Congress is needed to protect the shippers of rural America, who, by and large, do not have access to effective competition to meet their transportation needs.

To illustrate our attitude of cooperation with the OTVR, we have initiated contact with several current and potential shippers who are interested in increasing their usage of OTVR. Once we secured a verbal commitment to use OTVR, we then contacted OTVR and BN.

I want to share with you an actual situation that took place recently.

In April of 1987, TRAC contacted BN and OTVR about Tex Par Energy's problem with service and rates. Tex Par Energy ships oil from Western States and Canada to Garfield, Minnesota, and then distributes the oil by truck.

In 1986, Tex Par shipped a minimum of 105 cars and estimated a minimum of five cars per week or 260 cars annually in the future. Tex Par was happy with the service before BN sold to OTVR. Tex Par Energy liked the Garfield location and preferred to stay there. But, they were considering moving to Alexandria, Minnesota because the Soo Line would give them better rates and service.

When TRAC learned of Tex Par's problem of service and the need for lower rates, we contacted BN and OTVR. BN, by letter, agreed to meet with TRAC and Tex Par Energy and said they would contact TRAC. This meeting never took place because the BN never did contact us.

In May of 1987, we again checked with Tex Par Energy to see if BN had made any effort to negotiate rates and provide the needed services. Tex Par Energy had not been contacted.

Subsequently, Tex Par Energy became very upset when they had four cars of fuel in Fergus Falls that they needed in Garfield by the following Friday. OTVR said they could not deliver these until Monday. Tex Par told us that if they did not hear from BN and OTVR in regards to better service and rates by Wednesday of the following week that they would make their next oil shipment on the Soo Line to Alexandria, Minnesota.

Following the conversation with Tex Par, we contacted BN to inform them that Tex Par was very unhappy and was leaving OTVR unless they made some changes at once. They stated that they would have a meeting the following Monday and make an effort to do something. To date, as far as we know, BN has made no effort to contact Tex Par Energy. Subsequently, Tex Par Energy is now doing business with the Soo Line out of Alexandria, Minnesota—lessening the traffic on OTVR.

I share this example with the committee so that you know that it takes more than just local support and local people supporting a line to make it work. There are numerous other examples of the lack of attentiveness by both BN and OTVR of customers or potential customers on this line.

This type of inactivity by both BN and OTVR leaves us with only one conclusion, that they do not intend to keep the line viable.

In conclusion, we ask that you pursue such legislation that will protect rural shippers. Considering the economic input that a good rail system has on a community, the tax base it provides, the tax revenue to counties and subdivisions and the employment potential, such systems are crucial to rural America. Therefore, we are asking for the support and passage of the Consumer Rail Equity Act S. 676.

Finally, we believe there should be a screening process for sales of branch lines with the State Department of Transportation or some other local governing body involved in selecting a qualified buyer. In addition, the law should require reasonable notice and opportunity for shippers to be heard, and should require proof of financial viability on the part of the buyer. Further, any sale order should require the buyer to comply with all applicable State and Federal safety, crossings and property maintenance requirements.

Thank you, Mr. Chairman, for the time and effort you and this committee have put forth on behalf of rural America and captive shippers. I would be happy to provide any additional information upon your request.

STATEMENT OF THE ENVIRONMENTAL POLICY INSTITUTE

For fifteen years the Environmental Policy Institute has sought a sound national transportation policy. Several major obstacles have prevented the achievement of an efficient national transportation network, but the heavy subsidization of barge canals and heavy trucks has been of top concern. Railroads used to haul over 70% of the nation's freight, but now they carry less than 40%.

Rehabilitation of the nation's rail transportation system has to be the cornerstone of any effort to increase national transportation efficiency. There are important environmental benefits to be realized from a revitalized rail system. First, railroads move freight with far greater energy efficiency than trucks. Furthermore, unit trains, which compete with barges for the movement of bulk commodities, are as energy efficient and both are much more efficient than trucks. Second, installation of any transportation corridor does some environmental damage. Rail corridors do less than either highways or barge canals, and moreover, rail corridors are largely in place. Barge canals have destroyed significant amounts of fish and wildlife habitat through their construction and through ongoing dredging and spoil disposal. Heavy trucks do not pay their fair share of the highway damages they cause, and these bigger and longer trucks pose serious safety risks to the public. The nation has yet to come to grips with the incredible maintenance deficit caused by the alarming destruction of roads and bridges as a result of heavy trucks.

Despite these environmental benefits from rail transportation, the thrust of U.S. government policy has been the huge subsidization of barges and heavy trucks. According to one Library of Congress estimate, barges had received more net subsidy than all other transportation modes combined.

In this context EPI views the Staggers Act as having accomplished a significant revitalization of the rail industry to the benefit of the nation's overall transportation system. The condition of rail track in the 1970's was generally very poor, but now rail beds are much better maintained. Some branch lines are being revitalized. The Act seems to be working. In 1982 EPI opposed amending the Staggers Act, arguing that it should be given a chance to work. The evidence continues to mount that the objectives of rail revitalization are continuing to occur under the Act. For this reason, we believe that it would be unwise to amend the Act as the CURE bill proposes. Without the Staggers Act, the trend toward dominance of U.S. transportation by big trucks and commercial barges would have continued at an even more alarming pace.

STATEMENT OF THE EDISON ELECTRIC INSTITUTE

The members of the Edison Electric Institute (EEI) appreciate the opportunity to address the problems which exist in the implementation of the Staggers Rail Act of 1980. We believe there is a need for legislative action and urge you to adopt S. 676, the Consumer Rail Equity Act, to restore a degree of balance between the interests of railroads and captive rail shippers under the law.

EEI is the association of investor-owned electric utilities. Our members serve 97 percent of all customers served by the investor-owned segment of the industry. They generate approximately 76 percent of all the electricity used in this country and, service 73 percent of all ultimate customers in the nation.

Each of our nation's investor-owned utilities is under an affirmative obligation to purchase the least expensive reliable source of fuel that is available, to minimize the cost of electricity to our customers. The cost of coal delivered to our generating facilities is composed of the minemouth price and the cost of transportation. Railroads are far and away the primary carriers of coal to electric utilities.

The total delivered cost of our coal is paid by our customers, either through a fuel cost adjustment clause billing component or as a cost recovery element in base rates. Public service commissions do not allow utilities to make a profit on fuel costs.

Our message has as its foundation the critical relationship between the nation's railroads and U.S. coal-burning utilities. This relationship is complicated by the fact that many coal shippers and users have no alternative to service by a single railroad—they are what Congress referred to in 1980 as "captive shippers."

Because the marketplace provides no protection for captive shippers, the Staggers Act provides that the Interstate Commerce Commission (ICC or Commission) shall assure that the railroad rates charged such shippers are "reasonable." Through the adoption of a series of bad policies, however, the ICC has rendered the Staggers Act captive shipper protections virtually meaningless. Moreover, since the enactment of the Staggers Act, there have been a number of major rail mergers which have substantially increased concentration in the industry and in the process expanded the universe of captive rail shippers. We believe that Congress must act to put the ICC system back in balance by assuring that the captive shipper protections in the Staggers Act are implemented properly.

THE RAILROAD'S POWER OVER UTILITY COAL TRAFFIC

Three facts must be kept firmly in mind as one examines the respective experiences of railroads and rail shippers under the ICC's regulatory policies over the past six years:

(1) coal is the bread-and-butter commodity for the major U.S. railroads;

(2) electric utilities are by far the largest buyers and users of coal; and

(3) the cost of transporting this coal ultimately is paid by the consumers of electricity.

This critical link between railroads, utilities, and consumers provides the backdrop against which any serious discussion of rail regulatory policy must take place.

In 1985, electric utilities purchased nearly 700 million tons of coal. Almost two-thirds—445 million tons—was transported to power plants by rail. Electric utilities incur over $5 billion in rail freight charges each year, representing, on average, 35 percent of the total delivered cost of coal for power generation.[1] These rail freight charges are paid entirely by the utilities' ratepayers, and generate no profit or return for the utilities themselves.

The numbers are staggering from the railroads' side as well. Data developed by the Association of American Railroads (AAR) shows that the railroads carry more coal than any other commodity in terms of tonnage.[2] Since 1976, while the aggregate volume of all other commodities has declined, coal tonnage has risen steadily and significantly.

Coal also provides the railroads with the most profit of any commodity. Because most coal shipments move in highly efficient unit train and trainload hauls, variable costs of service per ton-mile [3] are less than half those of other commodities (43 percent), according to an EEI study.[4] Even the ICC acknowledges that coal is one of the most profitable commodities.[5]

Coal's profitability to the railroads is directly attributable to its status as a commodity that is largely captive to railroads. Because coal is a bulk commodity used in large volumes which must be shipped long distances, given the location of mines and power plants, it simply is not feasible or practical to use motor or water carriers to haul coal to many utilities. Potentially competitive technology exists in the form of coal slurry pipelines, but extensive railroad land holdings and rights of way and the absence of federal eminent domain authority have combined to keep coal pipelines on the drawing board and out of the transportation market. Finally, boiler design specifications and environmental regulations may in many cases operate to tie a utility to a specific coal source. In short, railroads often face no effective competition for hauling coal.

A study conducted for the ICC in 1982 [6] concluded that 53 percent of coal-burning utilities were effectively constrained from accessing competitive sources, railroads or modes in different geographic regions, a situation which was forecast to continue unabated well into the 1990's. A more recent EEI survey found that approximately 64 percent of utility rail coal tonnage is captive to delivery by a single railroad. The previously cited EEI analysis of coal profitability shows that the average "revenue to variable cost ratio" for coal was approximately 180 percent. For all other commodities, the average ratio was 128 percent. This disparity reflects the strong rail market power over captive coal transportation.[7]

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[1] Actually, in many cases the cost of transportation as a percentage of delivered fuel cost is much higher, and has been as high as 80 percent.

[2] In 1985, coal accounted for 40 percent of all tonnage originated by Class I Railroads. Source: "Analysis of Class I, Railroads—1985", Association of American Railroads, at pages 109 and 115.

[3] A ton-mile is a measuring unit which describes the movement of one ton of traffic one mile.

[4] *See* "Coal Profitability Relative to Other Commodities," Edison Electric Institute, August, 1985 ("Coal Profitability") at 3.

[5] Evaluation of Studies Prepared by the Edison Electric Institute, Interstate Commerce Commission, Bureau of Accounts, November, 1985, at p. 13. The ICC's analysis indicates that three other major commodity groups had higher profit margins than coal, but the volumes of these other commodities (and therefore the railroads' earnings from such commodities) pale in significance to the tremendous volumes of coal traffic carried by the railroads. In its January, 1986 update of its study, the ICC provides further data for 1982 and 1983 but this same statement is true for these subsequent years.

[6] "An Analysis of Source or Geographic Competition for the Delivery of Steam Coal to Utilities," Contract No. ICC-82-M-1731-D, July 26, 1982.

[7] Courts in antitrust cases have consistently held that the best indicator of market power is a firm's ability to set and maintain prices at supra-competitive levels. See, e.g., *United States* v. *E.I. duPont De Nemours & Co.*, 351 U.S. 377 (1956); *United States* v. *Grinnell Corp.*, 384 U.S. 563 (1966).

Recently, the ICC indicated its belief that the actual percentage of coal-burning utilities that are rail captive is small; somewhere on the order of 15–20 percent. This figure is based upon two studies, one conducted by the ICC staff, and the other by the Reebie Associates consulting firm. Both studies, however, are flawed, and grossly understate the problem of rail captivity for utility coal shippers.

The ICC study purported to compare railroad revenues from coal with rail service costs in an effort to determine how many coal rates were set at levels in excess of the revenue/variable cost ratio threshold for ICC jurisdiction—currently 180 percent. This "study," however, measured rail costs on the basis of total system averages—which reflect costs associated with movements of all sorts of commodities besides coal. Only a few of the adjustments to these costs routinely made and approved by the ICC in rail coal rate cases were made by the staff conducting the study. As a result, the costs are seriously overstated and the rate-to-cost ratios are correspondingly understated.

The Reebie Study is based on several assumptions which essentially "assume away" the captive shipper problem. The Study did not consider (a) long-term coal supply contracts binding coal users to specific sources; (b) environmental limitations on coal quality; or (c) existing legal and/

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The railroads constantly claim that they are a "competitive industry," and that administrative scrutiny of their rates and practices is therefore unnecessary. It is, of course, true that with respect to much of their traffic, railroads do face competition from trucks, other railroads, and/or barge operators. This does not change the fact, however, that for a significant portion of their traffic, including much of their coal traffic, the railroads encounter little or no competition. Regardless of what the precise percentage of captive coal shippers may be, the evidence makes clear the reality that a great many coal shipments—particularly those for electric power generation—are captive to individual railroads.

This railroad market power makes rates on these shipments particularly susceptible to abuse, a point recognized by Congress in the Staggers Act when it called for a balanced approach to rail regulation and carefully retained statutory protections for captive shippers. However, the experience since 1980 has been marked by repeated failures on the part of the ICC to strike the proper balance. For this reason, and out of the frustration borne by captive shippers under the current regulatory regime, we seek Congressional action.

THE ICC'S IMPLEMENTATION OF THE STAGGERS ACT HAS PREVENTED CAPTIVE COAL SHIPPERS FROM RECEIVING THE EQUITABLE TREATMENT CONGRESS INTENDED

Everyone who participated in the long and sometimes arduous legislative effort that went into the Staggers Act recognized that the final legislation represented a compromise of competing interests. The central compromise that made the Staggers Act possible was in the area of rail rates. Congress recognized that railroads needed the opportunity to generate sufficient revenues to achieve financial stability. Congress also recognized that captive rail shippers in general, and captive coal shippers in particular, should not be forced to pay excessive freight rates to railroads.[8] In crafting the Staggers Act, Congress carefully sought to balance these two policy concerns. However, the ICC has undermined the legislative balance by its decisions in a series of rulemaking proceedings which have ignored, eliminated, or severely curtailed the protections Congress sought to accord captive shippers.

Congressional Concern For Captive Shippers

Congress adopted as a Staggers Act policy goal: "to provide a regulatory process that balances the needs of railroads, shippers, and the public." [9] Insofar as rail ratemaking was concerned, Congress stated that the ICC should act "to foster sound economic conditions in transportation" while, at the same time, act "to maintain reasonable rates where there is an absence of effective competition." [10]

Maintenance of fair transportation rates on coal traffic was of particular concern to Congress. Congress considered coal traffic to be the prime example of a commodity over which railroads possess market dominance, and cautioned that railroads should not be permitted to meet a disproportionate share of their revenue needs by charging excessive rates on coal traffic. As stated by the Senate Commerce Committee concerning its version of the Staggers Act:

> This bill provides continued protection for shippers where such protection is necessary in the public interest. The [Senate] Committee [on Commerce, Science and Transportation] expects this protection to be utilized by the Commission to prevent extensive cross-subsidization or an excessive contribution from captive traffic. *The rates on coal are of particular concern in view of the many substantial increases imposed on this traffic in the last several years.* While recognizing that not all traffic can be transported at a fully allocated cost level due to competitive considerations, it is the Committee's intent that the Commission play an active role in insuring that such traffic bears its fair share of costs and that higher rated captive traffic is not unduly burdened. (Emphasis added).[11]

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or social barriers to new railroad entry or existing railroad expansion. It also assumed that the Commission would make aggressive use of its power to order reciprocal switching or terminal trackage rights to permit competitive access to coal sources and power plants.

[8] The goal of revenue adequacy was not intended to predominate over considerations of reasonable rates is made clear in the Report of the Committee on Conference on the Staggers Act: "The conferees intend that the Commission give due regard to two things whether a rate increase would mean excessive profits, and the need for a rate increase in light of the carrier's revenue position. . . . This language is not intended to imply that excessive profits for inadequate revenue carriers are reasonable." H.R. Rep. No. 96-1430, 96th Cong. 2d. Sess. 94 (1980).

[9] Staggers Rail Act of 1980, P.L. No. 96-448, § 3, 94 Stat. 1895, 1897 (October 14, 1980).

[10] Id. § 101(a), 94 State. 1897, codified at 49 U.S.C. § 10101a(5) and (6).

[11] S. Rep. No. 96-470, 96th Colng. 1st Sess. 7 (1979).

The Staggers Act Conference Report also emphasized Congress' special concern for coal:

> The Conferees intend that this [rail transportation] policy include the encouragement and promotion of the transportation of coal by rail in accordance with the objective of energy independence at rates which do not exceed a reasonable maximum where there is an absence of effective competition.[12]

Indeed, the Staggers Act is a compromise which passed solely because of assurances built into the structure and policies of the legislation that regulation would be maintained where marketplace competition was insufficient to protect captive shippers and the public from abusive practices by the railroads. As stated by Congressman Rahall, author of a key compromise amendment which enabled the legislation to pass:

> [M]y involvement in the rail legislation now before the House was to assure that a balance was struck, a balance which would allow carriers to achieve adequate revenues while providing protection for captive shippers against unjustifiably high rail rates. I believe this balance has been struck and urge support for the Conference Report.[13]

The legislative balance of shipper and railroad interests incorporated into the Staggers Act has been acknowledged repeatedly by reviewing courts in post-Staggers Act cases construing the Act.[14] Perhaps the best judicial expression of the balancing of interests that lies at the heart of the Staggers Act was provided in a 1984 decision by the D.C. Circuit overturning the ICC's decision to deregulate rail transportation of export coal:

> Congress recognized that sometimes competition would be insufficient to protect the legitimate interests of shippers, small carriers, and the public, and thus that full deregulation of the industry was unjustified by industry conditions. The legislation that eventually became the Staggers Act was subject to significant modification during floor debate, with many of the successful amendments supported by legislators who feared that the bills that emerged from the committees might not afford adequate protection to shippers where they might otherwise suffer from abuses of market power. The resulting Act was a compromise that enjoyed overwhelming support. Although the legislation was without doubt a significant reduction in railroad regulation, as this court has said, "The legislation * * * did not strip the Commission of its power and duty to protect shippers from the unreasonably high rates of carriers with market dominance." *Burlington Northern Inc.* v. *United States,* 661 F.2d 964, 973 (D.C. Cir. 1981). Both before and after the amendments the bills' sponsors agreed that the underlying approach of the legislation was to move toward much greater reliance on maket forces rather than regulation to govern rail carriage, but to temper that move with a policy of retaining regulation where the market would be insufficient to protect shippers and the public from abusive railroad practices.[15]

The text of the Staggers Act and its legislative history emphasize that the ICC must consider and balance the interests of captive coal shippers in its regulatory actions. Despite this clearly stated intent, the ICC has not accomplished the balancing task Congress intended it to pursue. Instead, through a series of general rulemaking proceedings and individual cases, conducted at a glacially slow pace, the ICC nurtured a one-dimensional regulatory environment which views the accumulation of railroad revenues and profits as the only goal worthy of serious service. For utility coal shippers, the combined effect of these actions has been to permit the market dominant railroads to establish and maintain unreasonably high rates on volume movements of their necessary fuel.

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[12] H.R. Conf. Rep. No. 96-1430, 96th Cong., 2d Sess. 80 (1980). The importance of coal to Congress is underscored by the fact that the quoted language was the only substantive comment in the Conference Report on the rail transportation policy in section 10101a.

[13] 126 Cong. Rec. H10086-87 (daily ed., Sept. 30, 1980).

[14] See e.g.; *Burlington Northern, Inc.* v. *United States,* 661 F.2d 964, 973 (D.C. Cir. 1981); *Cleveland-Cliffs Iron Co.* v. *ICC,* 664 F.2d 568, 587 (6th Cir. 1981); *Iowa Public Service Co.* v. *ICC,* 643 F.2d 542, 548 (8th Cir. 1981); *Union Pacific R.R.* v. *United States,* 637 F.2d 764, 767 (10th Cir. 1981); *Celanese Chemical Co.* v. *United States,* 632 F.2d 568, 577 (5th Cir. 1981) cert. denied *Atchison, Topeka & Santa Fe R. Co.* v. *United States,* 453 U.S. 950 (1981).

[15] *Coal Exporters Ass'n* v. *United States,* 745 F.2d 76, 81 (D.C. Cir. 1984) (footnotes omitted), cert. denied, 471 U.S. 1072 (1985).

During the last Congress, when members of this Subcommittee questioned the ICC's implementation of the Staggers Act, the ICC admitted the validity of some of the concerns of captive shippers and proposed various administrative changes. However, the ICC has retreated from many of the changes that it has proposed. Even where the ICC has adopted regulatory changes long advocated by shippers, the railroads have initiated litigation in an attempt to declare those changes invalid. The record of the ICC, which continues even now, is presented below.

Captive Shipper Rates Exceed Competitive Market Levels

Both the railroads and the ICC claim to have looked for abuse and found none. However, they have been looking in the wrong place. They attempt to focus the public debate on irrelevant numbers. As even the railroads' own studies show, a more meaningful period of time for viewing the extent to which captive rail rates have increased is the period since passage of the Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act).[16] During the period 1976-1980, when the ICC's then-current methodology showed that over one-third of the Class I railroads in the United States already were earning adequate revenues, rail rates on coal increased approximately 62 percent, far more than the rate of inflation, which was approximately 27 percent.[17]

The statistics cited by the ICC and the railroads do not answer the truly important question: whether the ICC has formulated policies which are allowing the railroads to charge excessive rates on captive coal traffic. For this answer, one must move from the analysis of average rates to all shippers and focus instead on the impact of ICC policies on the profits earned from individual rates to captive shippers.

In January 1986, the railroads issued an "analysis" of rail freight rates under the Staggers Act and throughout the period immediately prior to its passage.[18] Of the ten analytical tests applied in the study, however, none measured the most important element for purposes of this debate—the profitability of the rates under consideration. We submit that had the railroads focused on this aspect, the available evidence on coal profitability would confirm that ICC policies since 1980 have fostered excessive rail rates on captive coal.

When considering the railroads' cost of providing service, it is important to note that the vast majority of coal transported by rail moves in highly efficient unit train or trainload shipments. Also, utility shippers are increasingly providing their own equipment, thereby reducing the railroad's costs. Recent information indicates that utilities own more than 33,000 coal cars, a ten-fold increase over ten years, and have made substantial investments in terminal facilities. All of this must be considered in tandem with recent, substantial productivity increases in the railroad industry itself (e.g., reduced crew sizes, more efficient locomotives, decreased turn-around times, etc.)

A few utilities have recently experienced the benefits of newly-arisen competition and have negotiated rail contracts at reduced rates. Many, however, along with the majority of other coal shippers, remain without competitive alternatives and continue to pay rates which generate extraordinary returns.

The substantial rate reductions that have occurred in those few instances where competition has intruded into a formerly captive rail haulage situation also provide strong evidence that some captive shipper rates are excessive.

The City of San Antonio's problems with its Burlington Northern rail rates are well known. From 1976 to 1985, the San Antonio public utility, which was captive to the Burlington Northern for its Powder Basin, Wyoming coal, experienced an increase in coal rates from $10.93 to $27.66 per ton. In early 1985, after the Chicago and Northwestern Transportation Company (CNW) was allowed to enter the lower part of the Powder River Basin to compete with Burlington Northern, San Antonio received public bids from both railroads. When the bids were opened, the C&NW had won with an effective rate of approximately $19.60 per ton, a reduction of $8.06 per ton or 29 percent. In addition, Burlington Northern had offered to reduce its own rate $4.66 per ton, or 17 percent, in an effort to keep the business. The winning rate reduction per ton was greater than the amount of money San Antonio was paying for its coal at the mine mouth.

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[16] Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210,. 90 Stat. 31 (1976) (hereinafter cited as "4-R Act").

[17] See "Review of Association of American Railroads Paper 'Coal Rate Facts' ", Edison Electric Institute, June 1984, at 9.

[18] Railroad Freight Rates In The Five Years Since Staggers, Economics & Finance Department, Association of American Railroads, January 1986.

Certain other utilities in the Southwest benefited from this same infusion of competition, and received significant rate decreases, ranging from an estimated 18 to 29 percent at the time the contracts were signed. A summary of some of these cases is shown below:

THE EFFECTS OF COMPETITION ON RAIL RATES

Shipper	Old captive rate	New competitive rate	Reduction	Per cent reduction
San Antonio (City Public Service)	[1] $27.66	[2] $19.60	$8.06	29
		[3] $23.00	$4.66	17
Lower River Authority	[1] $26.67	[1] $22.00	$4.67	18
Arkansas Power and Light	[1] [4] $23.00	[2] $18.50	$4.50	20
Houston Lighting and Power	[1] $25.73	[1] $19.00	$6.73	26
Southwestern Service	[1] $17.50	[1] $12.50	$5.00	29

[1] Burlington Northern.
[2] Chicago Northwestern.
[3] Burlington Northwestern bid.
[4] Estimated.

A number of the tariff rates that were being charged to the utilities prior to the introduction of competition had been litigated before the ICC, and in each case the railroads took the position that they yielded earnings far below levels necessary to generate a sufficient return on investment to attract capital and produce a fair profit. Yet, when faced with the realities of the marketplace, significant reductions suddenly became possible.

Unfortunately, competition is not likely to develop for the majority of captive shippers. To the contrary, the trend among major railroads is not toward new market entry, but consolidation and concentrations of market power:

Burlington Northern acquired the St. Louis-San Francisco Railway in 1980.

The Chessie System Railroads and the Seaboard Coast Line Railroad were consolidated in 1980 under the umbrella of the CSX Corporation.

Union Pacific acquired the Missouri Pacific and Western Pacific in 1982.

In 1982, the Norfolk & Western Railroad and the Southern Railway were consolidated under the common control of Norfolk Southern Corporation.

In a case that is still pending before the ICC, the Sante Fe and the Southern Pacific are seeking authority to conduct operations under one corporate umbrella.

In a dramatic extension of intermodal market power, CSX Corporation acquired American Commercial Barge Lines in 1984.

The handsome returns which the major railroads are earning on volume coal movements, coupled with the dramatic reductions in rates which can (and do) occur when bona fide competition is introduced, demonstrate both the profitability of captive coal traffic and the rate victimization which takes place today in areas where competition does not exist. In some instances, excessive rates have been in effect since before 1980—and the ICC's policies have operated to preserve an inequitable situation. In others, those policies led directly to new rate increases, pushing rates to excessive levels. The existing regulatory system, which imposes no effective limitation on the degree of differential pricing which railroads are able to impose on captive shippers, is desperately in need of repair. After more than six years of this intolerable situation, it is to the Congress that captive shippers must turn for relief.

THE CONSUMER RAIL EQUITY ACT (S. 676) WILL REMEDY THE ICC'S FAILURE TO PROTECT CAPITIVE SHIPPERS

The law provides that a captive shipper who is concerned about a railroad rate may petition the ICC to have the reasonableness of the rate adjudicated. Prior ICC approval of rail rates is not required. Rather, the railroad establishes the rate by filing a tariff rate for the shipper in question. In certain very limited circumstances, the ICC does have the power to suspend a filed rate prior to its going into effect and/or to start an investigation into its reasonableness before it takes effect. In such a case, the railroad would bear the burden of proving the challenged rate to be reasonable, but the ICC has only used this investigation power in very rare circumstances since 1980. As a rule, therefore, if the shipper believes the rate is excessive, the shipper must petition the ICC for relief through the filing of a complaint once the rate has become effective.

To contest the reasonableness of a rate, a shipper must first prove that it is "captive" by proving (1) that it rate exceeds a jurisdictional revenue-to-variable cost threshold and (2) that it is subject to railroad "market dominance." Market dominance means that the shipper has no effective alternative but to ship the commodity in question via the railroad(s) charging the challenged rate. Having proved that it qualifies as a captive shipper, the shipper, not the railroad, must then carry the burden of proof as to the unreasonableness of the rate. Determination of rate unreasonableness involves the "revenue adequacy" test and the "rate reasonableness" test. In addition, a shipper cannot contest any rate increase which is based upon the ICC inflation index developed pursuant to Section 203 of the Staggers Act.

The tests for revenue adequacy, and rate reasonableness, along with the manner in which the ICC determines and applies its inflation index, are areas where the ICC's failure to implement Congressonal intent has had serious consequences for captive shippers. Each was the subject of separate ICC proceedings, which are discussed below. The ICC's handling of the matters at issue in these proceedings points out the type of legislative relief which is urgently needed to restore the balance of interests struck by Congress in 1980. Such relief, in an appropriate and carefully limited form, is contained in the provisions of the Consumer Rail Equity Act.

1. Revenue Adequacy

Chairman Gradison testified before the House Subcommittee on Transportation, Tourism & Hazardous Materials, on May 28, 1987 that "we do have financially sound carriers," but none are revenue adequate. This dichotomy occures because the ICC has consistently used standards for revenue adequacy which overestimate railroad revenue needs by billions of dollars per year. It is thus not surprising that the ICC has consistently determined that every Class I railroad in the United States is "revenue inadequate." [19] In order for the railroad industry to achieve "revenue adequacy" as defined by the ICC, shippers would have to contribute billions of dollars in additional freight revenues.

This situation is devastating to captive shippers because in every case where rail rates are challenged as being unreasonably high, the railroads refer to the massive influx of dollars the ICC has declared the railroads need in order to be "revenue adequate" as a justification for charging monopoly rates. The ICC also uses these massive "revenue shortfalls" as justification for refusing to implement the Long-Cannon provisions intended to protect captive shippers from management inefficiencies.

The ICC's view of the financial needs and revenue adequacy of the nation's railroads has distorted the balance between railroad revenue needs and individual rate reasonableness requirements which Congress sought to foster in the Staggers Act. In order to fully understand this problem, it is necessary first to understand three things: (1) why the concept of "revenue adequacy" is so crucial to the correct working of the Staggers Act; (2) the key errors in the ICC's standards for the determination of revenue adequacy; (3) how the ICC's most recent modification of this standard continues past flaws and adds new ones in its approach.

(a) The Importance of the Revenue Adequacy Concept in the Staggers Act

The "revenue adequacy" concept was born in the 4-R Act, which called upon the ICC to analyze relevant railroad financial data and determine which railroads are not financially sound, i.e., which railroads are "revenue inadequate." Revenue adequacy determinations are made annually for a single year period in the past. Such determinations affect rates subject to ICC regulation—rates to captive shippers—in several respects. For this reason, the regulatory function of these determinations is quite comparable to the function utility regulatory commissions perform when identifying revenue requirements for the companies they regulate.

The railroads claim to the contrary. They argue that revenue need standards used for utilities are inappropriate for railroads because of the "competitive nature" of most rail markets. This argument wholly misses the point, however. The concept of railroad revenue adequacy only has practical relevance in the context of captive traffic—traffic without effective competitive alternatives. As such, it is, in fact, a standard applicable only in monopoly circumstances.

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[19] See, e.g., Ex Parte No. 465, *Railroad Revenue Adequacy—1985 Determination*, decision served March 18, 1987.

In 1978, the ICC established regulatory standards and procedures for measuring railroad revenue adequacy,[20] deciding that it would look at "all pertinent financial indicators" to judge the financial strength of individual railroads. Using this approach, the ICC found that in 1978, 11 of the 31 Class I railroads enjoyed adequate revenues.[21] Despite urgings from the railroads during the Staggers Act debate that the Commission was improperly measuring railroad revenue adequacy, Congress refused to change the definition of revenue adequacy set forth in the 4-R Act. Congress did, however, direct the ICC to make revenue adequacy determinations each year.[22]

The Staggers Act also made structural changes in the law designed to give revenue inadequate railroads greater rate freedoms than revenue adequate railroads. Thus, Congress specifically required that the ICC consider its revenue adequacy findings in individual rate cases. The ICC Coal Rate Guidelines establish revenue adequacy over a period of time as a rate constraint, and provide any showing of sufficient management inefficiency to account for a railroads' inability to attain revenue adequacy may also constrain rates.[23] The Staggers Act also required the ICC to give "due consideration" to a railroad's revenue adequacy status in evaluating challenges to rate increases within the 6 percent "zone of rate flexibility" applicable through October 1, 1984;[24] precluded revenue adequate railroads from using the rate freedoms under the four percent rate flexibility zone commencing in October, 1984; and required the Commission to take into account the revenue adequacy of a railroad in connection with the rate surcharge provisions of the Staggers Act.[25]

Given the role which the revenue adequacy concept plays under the Staggers Act, it is of fundamental importance that the standards used to determine a railroad's revenue adequacy comport with financial reality. To the extent that the ICC overestimates a railroad's revenue needs and declares a railroad to be revenue inadequate when in reality it is not, the entire structure of the ratemaking provisions in the Staggers Act is skewed. This is precisely what has happened beginning with the ICC's 1981 *Ex Parte No. 393* decision.[26]

(b) The Commission's Ex Parte No. 393 Decision

Soon after the Staggers Act was passed, the ICC initiated a rulemaking proceeding for purposes of "revising" the standards it had previously used for purpose of making revenue adequacy determinations. In this proceeding the Commission decided to determine railroad revenue adequacy based solely upon a railroad's return on the total value of its assets. Briefly, it concluded that a railroad is considered revenue adequate if its return on investment equals or exceeds the industry average cost of capital for that year.

Using this criterion, the Commission determined that only three railroads were revenue adequate in 1980, two small railroads in 1981, and none thereafter. The Commission also determined that the "revenue shortfall" (the difference between the amount of money the railroads need to receive to be revenue adequate and the amount they are receiving) for Class I railroads amounted to several billion dollars.[27]

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[20] Ex Parte No. 338, *Standards and Procedures for the Establishment of Adequate Revenue Levels,* 358 I.C.C. 844, modified, 359 I.C.C. 270 (1978).

[21] Ex Parte No. 353, *Adequacy of Railroad Revenue (1978 Determination),* 362 I.C.C. 198 (1979).

[22] Staggers Act § 205(b)(2), 94 Stat. 1906, codified at 49 U.S.C. § 10704(a)(3), (4).

[23] Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines-Nationwide,* (Decision served Sept. 3, 1985).

[24] Under Section 203(a) of the Act (codified at 49 U.S.C. § 10707a (c) and (d)), Congress established "zones of flexibility" with respect to rates. Between October 1, 1980 and September 30, 1984, railroads were permitted to take annual rate increases of up to 6 percent, after inflation. As of October 1, 1984, the flexibility zone was reduced to 4 percent per year, and is only available to revenue inadequate carriers. Rate increases within the zone cannot be suspended by the ICC prior to their effectiveness, and can only be investigated on the Commission's own initiative under limited circumstances. A shipper, however, can still file a complaint challenging the reasonableness of a rate as augmented by an increase within the flexibility zone.

[25] Section 217 of the Act gave railroad parties to joint rates the power to impose unilateral surcharges on their portion of the joint rate without the necessary concurrence of other connecting carriers. This mechanism was designed to allow railroads with disproportionately low shares of joint rates to increase their revenue without having to convince the other participants to either raise the entire rate or reduce their own shares. The surcharge power expired on October 1, 1984.

[26] Ex Parte No. 393, *Standards for Railroad Revenue Adequacy,* 364 I.C.C. 803 (1981).

[27] See e.g., *Ex Parte No. 457, Railroad Revenue Adequacy—1983* (served January 4, 1985).

While these ICC revenue adequacy standards used financial terminology similar to that used by the financial community and other regulatory agencies, the actual regulatory precepts used were and are far different from those generally applied to regulated industries—and electric utilities in particular. As stated by Dr. Wesley H. Long, District of Columbia Public Service Commissioner and Chairman of the National Association of Regulatory Utility Commissioners' (NARUC) Subcommittee on the Staggers Act Implementation:

> The ICC's methods result in oversight costs and understated returns on the railroads' investment. The end result is that rail freight customers, especially those, such as coal shippers, having no other practical means to transport their freight, are burdened with excessive transportation costs. Such costs are passed on to the consuming public in the form of higher rates for electricity and other goods or commodities.[28]

The ICC substantially overstated railroad revenue adequacy requirements in a number of ways. For example, in making revenue adequacy determinations:

> The ICC computed the cost of capital using the current, market cost of debt rather than the embedded cost of debt which the railroads actually pay.

The embedded cost of debt represents the actual amount of money a railroad is contractually obligated to pay as interest for borrowed funds. Regulatory commissions generally consider debt at this actual, incurred costs. In a Verified Statement which Dr. Alfred E. Kahn recently prepared to support EEI comments to the ICC on this issue, he stated:

> [I]t is only the embedded, actual money cost of debt that it is necessary to permit the railroad entity in question to earn in order fully to compensate investors and attract capital, as the Staggers Act contemplates. . . . Under an authentic original-cost revenue adequacy determination, the embedded cost of debt become like wage rates or the cost of fuel; the railroads are entitled, logically, to get back those actual money outlays, along with the current market cost of equity capital, nothing more or less.[29]

Much railroad debt was issued many years ago, when interest rates were lower than those which currently prevail. However, the ICC pretends that all debt was issued in the year under analysis, at then current costs. This overstates the true cost of railroad debt and, thus, the revenues needed to meet that cost. For example, in 1985, the embedded cost of railroad debt was 8.3 percent, while the ICC determined the current cost of such debt was 11.1 percent.[30]

The railroads claim that a new investor can be assured of earning the current cost of debt only if a railroad's entire debt capitalization earns the then-current debt cost. This is incorrect. An investor only needs assurance that the portion of the investment base funded by new debt will earn the then current return for that debt. A properly computed embedded cost of debt (which takes into account the current cost of new debt as it is incurred) will guarantee that each and every individual debt issuance will be considered in the determination of the cost of capital and thus will ensure that an investor's expectations (for a return on debt at the level current at the time the debt was incurred) will be met.

The railroads also rely upon the competitive and "contestable" market theory to claim that the imaginary, current debt cost must be used. They claim that during times of low interest rates, when a new entrant's capital costs would be lower than the existing railroad's costs, the existing firm's rates will be limited by the new entrant's lower cost of debt and that measuring their financial performance using imaginary, current debt costs during periods of high interest rates is necessary so that this "shortfall" can be balanced out.

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[28] NARUC Press Release, July 22, 1985.

[29] Verified Statement of Alfred E. Kahn dated July 31, 1986, attached to EEI Comments to ICC in *Ex Parte No. 393 (Sub-No. 1)*, dated August 4, 1986.

[30] Ex Parte No. 464, *Railroad Cost of Capital—1985*, served March 16, 1987. The ICC estimated the railroads' embedded cost of debt for 1985 to be *9.8* percent. The petition of Edison Electric Institute for Reconsideration in this matter indicates that this estimate is based on a limited sample of companies and that when all Class I railroads are considered the embedded cost of debt for 1985 becomes *8.3* percent. The railroads now claim that for all Class I railroads, the embedded cost of debt for 1985 was *8.5* percent. The railroads now claim that for all Class I railroads, the embedded cost of debt for 1985 was *8.5* percent. Response of the Association of American Railroads in opposition to Petition of Edison Electric Institute for Reconsideration, April 27, 1987.

There are several flaws in this argument. First, all companies—regulated and competitive—regularly refinance debt when interests rates decline. Electric utilities refinanced over $11 billion in debt in 1968 alone.[31] The railroad response to this point is that a substantial portion of their debt can not be refinanced. However, this response reveals that their actual business practices do not comport with the theory they advocate, for if the "contestable" market theory were controlling, the railroads would maintain the flexibility to reduce debt costs when interest rates declined.

The railroads also incorrectly assume that the ICC will cap all railroad revenues once it finds a railroad is revenue adequate. This assumption ignores the fact that the ICC's authority over rates is limited, and that the ICC has stated a railroad must be revenue adequate over several years before it will apply revenue adequacy as a constraint on a rate to a captive shipper.

Departure from the embedded cost of debt approach can significantly distort the depiction of railroad financial health by over estimating railroad costs when the current cost of debt exceeds actual embedded costs. If the current cost of debt declined below embedded rates, a railroad could refinance debt (as many individuals and corporations did recently), in which case its embedded costs would be reduced. If it did not refinance, use of the current cost standard would underestimate its costs. In comparison, an embedded cost standard would always produce a figure at the level of actual railroad debt costs.

> The ICC treated funds from deferred taxes as though they were obtained at the current market cost of private capital, even though such funds are obtained at no cost. This overstated the true revenue needs of the railroads.

Deferred tax funds are acquired at no cost to the railroads, but they were treated by the ICC as having been obtained at the current cost of capital. This further overstated the revenue needs of the carrier being analyzed, and had the effect of forcing captive shippers to cover imaginary railroad costs. Other utility regulatory commissions generally treat funds from deferred taxes as having no cost, or exclude such funds from the company's investment base. Both approaches provide the regulated entity the opportunity to use the funds while protecting customers from having to cover imaginary costs.

The railroads argue that failing to include deferred taxes in a railroad's investment base would deprive the railroad of the opportunity to earn a return on these funds. This argument is incorrect. In competitive markets, railroads would have the same opportunity as unregulated businesses to maximize their return from deferred taxes. However, to the extent that the attainment of revenue adequacy serves as a constraint on rates to captive traffic, exclusion of deferred taxes from the investment base assures that rates to captive shippers would be based on capital costs actually incurred in providing rail service, and not on additional imaginary costs as well.

> The ICC determined railroad debt-equity ratios on the basis of current market levels, rather than actual book value levels, and made no judgment as to the prudence of the railroads' capital structures.

The ICC makes no determination regarding the prudence or reasonableness of each railroad's capital structure, but relies upon market value debt-equity ratios which bear no necessary relation to the realities of a railroad's actual capital structure requirements. In fact, such ratios provide for extremely high proportions of equity and thus force captive shippers to provide the railroads with revenues to cover capital costs that are unnecessarily high.

> The ICC failed, by its own admission, to ensure that all railroad-related revenues, investments and expenses are included in the revenue adequacy determination.

Any determination of railroad revenue adequacy should take into account all revenues, investments and expenses reasonably related to the provision of railroad service. The ICC, however, had no mechanism to comprehensively identify and scrutinize such data. This can have significant impact upon the accuracy of the revenue adequacy determination. For example, if that determination is based upon an excessive investment base, the revenues required to attain revenue adequacy will be overstated. Conversely, if rail-related income is not included in the revenue adequacy equation, the financial health of the railroads will be understated.

> The ICC's revenue adequacy methodology provided no opportunity to analyze or contest data supplied by the railroads.

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[31] Analysis of Public Utility Financings—Year 1968, Ebasco Business Consulting Co., January 1987.

Although the revenue adequacy determination has a clear relationship to rates for captive shippers, the ICC revenue adequacy determination procedures rely almost exclusively upon data supplied by the railroads. With the exception of the cost of capital determination, shippers and the public have no opportunity to participate in revenue adequacy determinations to scrutinize and comment upon the railroads' representations to the ICC.

Perhaps the best example of the problem with the ICC's revenue adequacy standards involved the Norfolk Southern Corporation. The Norfolk Southern controls the Norfolk & Western and Southern Railways, from which it derives the vast majority of its revenues. Both of these railroads have been determined to be revenue inadequate by the ICC because their "rates of return", as calculated by the ICC in its most recent (1985) determination, are less than 9.1 percent—significantly below the 13.6 percent return the ICC established as the minimum needed to achieve revenue adequacy at the time. During this period, the Department of Transportation chose the Norfolk Southern as its candidate to purchase Conrail—at a cost of at least $1.2 billion—specifically because of its vibrant financial health, prospects for long-term profitability, and anticipated resilience in the face of future potential economic downturns. The DOT's long-term analysis directly contradicts the ICC's attempt to explain Norfolk Southern's cash-rich position as merely an aberration brought about by one-time tax write-offs.

In the words of an ICC Administrative Law Judge: "Using the present method of arriving at a finding as to which carriers are revenue adequate it will be difficult if not impossible for any carrier to be considered revenue adequate." [32] The methodology for measuring railroad financial health as defined by the ICC was unique, not consistent with methods applied by other regulatory bodies and virtually guaranteed to understate the financial health of the major coal-carrying railroad.

(c) The ICC's First Proposed Revisions to the Revenue Adequacy Standards Would Have Exacerbated the Problem

The ICC first proposed to revise its revenue adequacy standards in 1983.[33] At that time, rather than make its approach more consistent with that of other regulatory agencies, the ICC's proposal would have obscured railroad financial health even further. The most consequential of the proposals would have valued the railroads' investment base on the basis of current cost rather than original cost. (It is unclear whether the ICC intended to apply reproduction or replacement cost.) Adoption of this methodology would by itself have increased the railroad industry's apparent revenue "needs" very substantially. For example, under that proposal, virtually all railroads, including the Norfolk & Western and Southern, would actually have reported negative returns in 1983.[34]

(d) Recent ICC Revisions Continue to Overestimate Railroad Investment Base and do not Remedy Major Deficiencies in its Standards

Although Chairman Gradison of the ICC defended the Commission's revenue adequacy standards in her February 6, 1986 testimony before the House Subcommittee on Commerce, Transportation and Tourism, in testimony before this Subcommittee just two weeks later, on February 21, 1986, she stated that the ICC unanimously recognized that is revenue adequacy standard were flawed. Specifically, in her written statement to this Subcommittee on behalf of the ICC, Chairman Gradison stated:

> . . . we agree that our existing standards and procedures for determining revenue adequacy are not producing a realistic picture of the financial condition of the rail industry. The Commission's most recent revenue adequacy determination finds that in 1984 no railroad was revenue adequate. In fact, comparison of our revenue adequacy determinations for each of the five years from 1980 through 1984 shows a decline in the economic health of most of the major carriers, and only a minor improvement for others. This is directly contrary to the general perception shared by the government, the rail industry, the shipping public, and the investment community, that the financial condition of the railroads has improved substantially since passage of the Staggers Act. We have therefore concluded that our present

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[32] No. 37854S, *Consumers Power Company* v. *Norfolk & Western Ry. Co.* Decision served January 18, 1984.

[33] Ex Parte No. 393 (Sub-No. 1), *Standards For Railroad Revenue Adequacy,* Decision served March 9, 1983.

[34] Ex Parte No. 457, *Railroad Revenue Adequacy—1983 Determination,* served January 4, 1985, Appendix C, p. 1.

standards, including our past decision not to consider multiple financial indicators must be reassessed.[35]

On June 5, 1986, the ICC proposed to revise its revenue adequacy standards.[36] Specifically, it proposed:

Continued use of original cost accounting;

Use of the embedded cost of debt in determining the overall cost of capital;

Use of actual book values of debt and equity for determining capital structure;

Treatment of funds from deferred taxes as a zero-cost source of capital or deducting them from investment base;

Revision of the return on investment analysis to more accurately reflect rail-related activities; and

Use of depreciation accounting for track structures.

These proposals were consistent with changes shippers had long sought and suggested that the ICC had at long last recognized that the problems with its revenue adequacy findings were due to its use of a flawed methodology.

However, on October 7, 1986, the ICC held a voting conference in which it substantially retreated from its earlier proposal. The ICC retreated from its proposal to use the embedded cost of debt and continued use of the current cost of debt, together with market value debt-equity ratios. The ICC also applied a more limited test to identify rail-related investment than it had previously proposed and indicated that guidelines for the implementation of this test would be considered in a separate rulemaking proceeding. (A proposal to provide for reporting of the necessary information was served on May 11, 1987. Ex Parte No. 393 (Sub-No. 2), *Supplemental Reporting of Consolidated Information Revenue Adequacy Purposes.*) The ICC continued use of historic cost accounting and adopted one major shipper-supported change when it agreed to deduct funds provided by deferred taxes from investment base because such funds are a zero-cost source of capital.[37]

Finally, the ICC approved a transition from railroad retirement-replacement-betterment accounting (RRB) to depreciation accounting (DA) for track structures. The ICC implemented the mechanics of this transition by a conversion process which increases railroad investment base by $7 billion. This $7 billion increase is caused solely by the conversion process approved by the ICC (a process which was not used when the railroads adopted DA for federal income tax purposes.) Shippers strongly opposed this write-up because there is substantial basis to conclude that the railroads recouped essentially all of their $7 billion, when track outlays were originally recorded as expenses in the year incurred. The ICC justified this addition of $7 billion to the investment base because the railroads were revenue inadequate in the past—but it applied a past revenue adequacy standard which it had admitted was flawed. Essentially, the ICC rationalized that the railroads' inability to meet its prior overstated revenue adequacy targets justified an accounting conversion which exaggerates the railroads' revenue needs for years into the future.

This attempt at retroactive ratemaking, particularly when based upon such faulty data, is directly contrary to utility commission practice. As Commissioner Long indicated in his June 3, written statement to the House Subcommittee on Transportation, Tourism & Hazardous Materials:

> Public utility commissions do not, in fact cannot, retroactively attempt to make utilities whole. They can only provide an *opportunity* on a going forward basis to earn a reasonable rate of return. (Emphasis added).[38]

Several suits have been filed to challenge this recent revenue adequacy decision. The railroads are likely to contest the ICC's decision to exclude funds from deferred taxes from investment base.

On March 18, 1987, the ICC issued its first decision on railroad revenue adequacy under its revised standards.[39] No Class I railroad was found to be revenue adequate in 1985. Two major issues—the use of the current cost of debt and the addition of $7 billion to railroad assets discussed earlier—significantly affected this determination by considerably overstating railroad revenue needs. Chairman Gradison wrote separately to suggest that use of the embedded cost of debt would not have significant impact on a railroad's revenue adequacy status. She stated: [40]

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[35] Written Statement of ICC Chairman Gradison, before Senate Commerce Committee, Surface Transportation Subcommittee, February 21, 1986, at 12-13.

[36] Ex Parte No. 393 (Sub-No. 1). *Standards for Railroad Revenue Adequacy,* (Notice of Proposed Rulemaking) Decision served June 5, 1986.

[37] Ex Parte No. 393 (Sub-No. 1), *Standards for Railroad Revenue Adequacy,* (Final Rule), Decision served December 31, 1986.

[38] Testimony of the Honorable Wesley H. Long, District of Columbia Public Service Commission, on behalf of the National Association of Regulatory Utility Commissioners. Submitted to House Committee on Energy and Commerce, Subcommittee on Transportation, Tourism and Hazardous Materials (June 3,1987).

[39] Ex Parte No. 465, *Railroad Revenue Adequacy—1985 Determination,* Decision served March 18, 1987.

> In our decision in Ex Parte No. 464, Railroad Cost of Capital—1985, we estimated that the embedded cost of debt for 1985 was 9.8 percent. We also indicated that the average current yield on railroad bonds was 9.2 percent in early 1987. Thus, it seems likely that for 1987 (and perhaps 1986) the embedded cost of debt will be higher than the current cost.

Although Chairman Gradison relied on an "estimate" of railroad embedded debt, the actual cost of debt for all railroads is an easily determined figure. The actual (embedded) cost of railroad debt in 1985 was 8.3 percent.[41] This is 150 basis points lower than the ICC estimate on which Chairman Gradison relied and 280 basis points lower than the 11.1 percent current cost of debt which the ICC applied for 1985.

Chairman Gradison also specifically indicated that elimination of the "double-count" of expenses that resulted from the conversion from RRB accounting would not have a "significant impact" on a railroad's revenue adequacy status.[42] However, she never specifically quantified the impact of the addition of $7 billion to rail investment base. Instead, she simply concluded that the write-up is less than "the railroads' large revenue shortfalls in the past, over $12 billion in 1983 and 1984 alone. . . ." [43]

In comparison, an estimate of the impact of the write-up on the 1985 return on investment for nine Class I carriers reveals that the ROI for each carrier would increase by 20 to over 60 percent if the write-up in asset values caused by the conversion from RRB to depreciation accounting were not included in their investment base. This information is presented in Table 1 below.[44] The ROI of one carrier would increase by over 300 basis points if the write-up was excluded from the investment base.

In short, Chairman Gradison and the ICC used so-called "accounting technicalities" as a means to continue to exaggerate the current revenue needs of the railroads and did so without ever considering whether such inadequacies were due to regulatory constraints, competitive constraints or management inefficiencies. Moreover, they have failed to consider whether captive shippers paid their fair share of railroad revenue needs in the past and whether it is fair to impose upon current shippers the burden of alleged past deficiencies.

Vice Chairman Lamboley dissented from the most recent revenue adequacy decision and subsequent applications and specifically supported use of the embedded cost of debt, alternative rules for the transition to depreciation accounting and other shipper-supported measures.[45] Commissioner Simons also stated for the record that "our revenue adequacy standards continue to yield unrealistic results."

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[40] Decision at 7.

[41] Ex Parte No. 290 (Sub-No. 2). The AAR also identified 8.3 percent as the 1985 embedded cost of debt in *Railroad Cost Recovery Procedures*, Comments of the Association of American Railroads in Response to the Commission's February 17, 1987 Notice of Proposed Interpretation of Rule Regarding Methods of Indexing the Interest Component of the "All Inclusive" Index, Verified Statement of Harvey Levine at 5. As indicated in note 29 above, the AAR now claims the embedded cost was 8.5 percent in 1985, still far below the ICC estimate.

[42] Decision at 7.

[43] Decision at 7.

[44] Submission of Potomac Electric Power Company to Railroad Accounting Principles Board, April 20, 1987, Table No. 1.

[45] Ex Parte No. 466, *Railroad Cost of Capital—1986* (Decision served March 20, 1987).

TABLE NO. 1.—1985 EARNED RETURN ON INVESTMENT ADJUSTED TO EXCLUDE THE EFFECTS OF THE ACCOUNTING CONVERSION WRITE-UP TO DEPRECIATION ACCOUNTING

Carrier	ICC determination of earned return on investment 1985 revenue adequacy decision issued March 16, 1987, including the write-up caused by the accounting conversion from RRB to depreciation accounting [1]	1985 revenue adequacy determination of earned return on investment pro formed to exclude the write-up caused by the accounting conversion from RRB to depreciation accounting	ICC determination understatement	
			Percent amount	Percent of ICC determination
Burlington Northern	10.29	13.41	3.12	30.32
Chesapeake & Ohio	11.10	13.41	2.31	20.81
Baltimore & Ohio	4.28	6.15	1.87	43.69
Denver and Rio Grande Western	5.62	7.57	1.95	34.70
Grand Trunk Western	1.64	2.37	.73	44.51
Seaboard Railroads	7.95	9.12	1.17	14.72
SOO Line	1.46	2.40	.94	64.38
Southern Railway Systems	8.06	10.74	2.68	33.25
Union Pacific	7.34	9.01	1.67	22.75

[1] Decision in ex parte No. 465, railroad revenue adequacy—1985 determination, decided March 2, 1987.

Note: The ICC determined the 1985 cost of capital to be 13.6 percent.

Despite these dissenting views, the ICC continues its course of artificially inflating railroad revenue needs and of depicting the financial condition of the railroads to be far worse than reality. This offers shippers little basis for confidence in the ICC.

Chairman Gradison's May 28 discussion with members of the House Subcomittee on Transportation, Tourism & Hazardous Materials about the revenue adequacy concept also offers shippers little consolation. In that discussion she acknowledged there are "financially sound" railroads, but none are revenue adequate, thus pointing out the very problem shippers have raised for so long.

Chairman Gradison also de-emphasized the importance of the revenue adequacy concept, suggesting its only role is to allow carriers to take increases under the zone of rate freedom. However, revenue adequacy has had a far more substantial role. As we have shown, the ICC relies on past revenue inadequacy to justify a $7 billion increase in railroad investment base—thereby increasing rail revenue needs for years into the future. In the *Arkansas Power & Light* case, the ICC found a showing of management inefficiencies, valued at hundreds of millions of dollars, did not warrant relief because the amount of the inefficiencies did not exceed the amount the railroad required to be revenue adequate over time.[46] If the revenue adequacy test had not overestimated revenue needs, relief may well have been granted. Thus, the concept of revenue adequacy continues to serve an important function in ICC decisionmaking.

(e) The Consumer Rail Equity Act Would Correct the Errors in the ICC Revenue Adequacy Standard

Some relatively simple statutory provisons addressing standards for revenue adequacy would effectively correct the flaws in the methodology presently employed by the ICC and bring the ICC's depiction of the railroads' financial health more in line with that seen by the financial and investment communities and the general public. Such an approach is embodied in Section 7 of the Consumer Rail Equity Act. In short, it would:

require that revenue adequacy determinations be based upon all actual investments, revenues and expenses reasonably related to rail services;

exclude no-cost deferred tax funds from the investment base upon which the revenue adequacy determination is made;

require that the cost of debt be based upon the actual cost of debt incurred by the railroad under scrutiny;

require that the cost of equity capital be determined on the basis of all relevant financial information;

prevent inclusion in asset base of costs previously charged as an operating expense; and provide the public an opportunity to review and comment on the information the railroads submit for the annual revenue adequacy determination.

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[46] Docket No. 36719 et al, *Arkansas Power & Light Co.* v. *Burlington Northern Railroad Co.*, (Decision served May 13, 1987) at 10–12.

Determinations of revenue adequacy based upon these elements will result in much more accurate portrayals of a rail carrier's financial health and of the levels of differential pricing which legitimately may be imposed upon captive shippers. Under a methodology employing these elements, several of the same railroads found by the ICC to be revenue adequate in 1979, and whose financal condition has improved steadily since the late 1970's, today properly would be considered at or near revenue adequacy. Such results would be fully consistent with the concept of revenue adequacy as established in the 4-R Act and reaffirmed in the Staggers Act.

2. Coal Rate Guidelines

The electric utility industry has never opposed the concept of differential pricing. We know that for carriers to recover their full costs (plus a return) on all traffic, some capitive traffic must be subject to above full-cost rates in order to offset below full-cost (but still compensatory) rates on competitive traffic. Such a principle is built into the Interstate Commerce Act, and we have no desire to see it purged. What we do strongly object to, however, is use of the term "differential pricing" as a talisman to justify excessive rate levels on captive—especially coal—traffic. The law clearly places limits on the extent to which captive shippers may be subjected to differential pricing. In its deliberations since 1980 on the subject of Coal Rate Guidelines, however, the ICC has, as a practical matter, refused to recognize them.

The Coal Rate Guidelines proceeding[47] was begun in 1978 to establish ratemaking standards to apply in individual coal rate cases at the ICC. The final guidelines were issued in this proceeding on September 3, 1985—some seven years after the proceeding was initiated. During this seven year period, numerous individual rate cases were heard by the ICC, which were decided using various "interim" ratemaking standards.

Indeed, one of the ICC's Administrative Law Judges took the extraordinary action, in a published opinion, of telling shippers not to bring cases because, regardless of the merits, the ICC would never grant any relief. As stated by ALJ Hopkins:

> While it might again be tilting at windmills, it appears to this Administrative Law Judge that the complainants are wasting an enormous amount of time, energy and money, proceeding with these cases before a Commission that has clearly shown that it is unable or unwilling to find a complained of rail rate to be above a maximum reasonable level where a carrier is not revenue adequate. The question as to what aspects go into deciding revenue adequacy is another matter. The Staggers Act as presently construed, even though on an interim basis, without Congressional changes and with a Commission as presently constituted, leaves no hope for complainant shippers.[48]

While the ICC's new Coal Rate Guidelines purport to balance the interests of railroads, shippers and the general public, in fact they do not provide meaningful protection for captive shippers as required by the Staggers Act. The ICC has adopted what it terms the "constrained market pricing methodology." This methodology contains four purported "constraints" on railroad pricing of captive traffic: the Stand-Alone Cost Constraint, the Revenue Adequacy Constraint, the Management Efficiency Constraint, and the Phase-In Constraint. An analysis of each of these "constraints" and their principal defects follows.

(a) The Stand-Alone Cost Constraint

Under this "constraint," a shipper must prove that a rate is unreasonable by proving that it is higher than the cost the shipper would have to pay to provide the same service itself, or to obtain the same service from a hypothetical alternative transportation source. Since a stand-alone railroad hauling only the traffic of the complaining shipper will be astronomically expensive in all cases, a shipper first will have to analyze what other traffic also could be carried by the stand-alone railroad. Next, it will have to determine what rail plant (land for right-of-way, rails, ties, bridges, road crossings, maintenance facilities, signalling systems, etc.) and equipment (locomotives, cars, maintenance equipment, etc.) would be required to handle the defined traffic base. In order to make this determination, it also will be necessary for the shipper to work out an operating plan and define the labor force for the stand-alone railroad.

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[47] Commenced as Ex Parte No. 347, *Western Coal Investigation—Guidelines for Railroad Rate Structure* (notice served May 11, 1978); Ex Parte No. 347 (Sub-No. 1) *Coal Rate Guidelines—Nationwide* (Decision served Sept. 3, 1985) (Final decision).

[48] Docket No. 378538, *Consumers Power Co.* v. *Missouri Pacific Railroad Co.*, Decision served January 18, 1984, at 8.

Once the operating plan, labor force, railroad plant and equipment requirements for the theoretical railroad have been established, the shipper must demonstrate what the cost of this entire enterprise would be. The final step would be to show what portion of the cost of the stand-alone railroad should be borne by each segment of the traffic it would carry. All of this analysis must be conducted on the wholly theoretical proposition that a stand-alone transportation alternative could somehow be possible, although in the real world numerous factors may rule out construction of alternative transportation systems regardless of economic considerations. Operating on this theoretical level necessarily entails tremendous uncertainty and speculation and presents fertile ground for dispute between the parties in a context where "real" facts may provide the ICC little basis for resolving issues. Even where the shipper attempts to demonstrate the cost of a stand-alone railroad based on the existing plant and operations of the railroad(s) providing the service under the challenged rate, the factual issues are of comparable complexity.

The shipper bears the burden of proof with regard to each and every element of this exercise of establishing the traffic base, plant and equipment requirements, operating parameters and labor requirements, costs and demand-based rate structure for the mythical stand-alone railroad. In order to make the detailed evidentiary showings required to attempt to satisfy the requirements for a stand-alone cost analysis, a shipper must retain witnesses with expertise in at least the following areas: railway engineering, signalling systems, train operations, equipment maintenance, maintenance-of-way, railroad accounting, economics, and costing, as well as specialized counsel. This team of experts must then devote a massive amount of time to (a) efforts to obtain information necessary to conduct the required analysis, much of which is in the sole possession of the railroad and must be sought through the Commission's discovery procedures, (b) conduct and present the requisite analysis, (c) respond to railroad attacks on the analysis, and (d) dissect the counter stand-alone analysis which will ordinarily be presented by the railroad.

In short, the stand-alone cost constraint is, at best, a witheringly complex undertaking, entailing a massive amount of effort and tremendous expense. For this reason alone, it is totally out of the question as a meaningful "remedy" for many captive rail shippers. Even for those few shippers who may be able to afford to pursue a stand-alone cost case, under this type of analysis only shippers who are moving very large volumes of traffic for long periods of time over high density rail lines where a large percentage of the traffic is coal or other bulk commodities will have any faint hope of obtaining relief.

(b) The Revenue Adequacy Constraint

As spelled out in the ICC's Guidelines, the revenue adequacy constraint dictates the "captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs." Apparently, the only way this constrant could be used to show an individual rate to be too high would be for a shipper to establish (a) that the railroad involved is revenue adequate, and (b) that the degree of differential pricing reflected in the challenged rate is not necessary for the railroad to remain revenue adequate.

As to the first element of this showing, the Guidelines make it clear that existing revenue adequacy standards will apply. The Guidelines stress that revenue adequacy is a long-term concept, and that the fact that a railroad may have adequate revenues for one or more years does not establish that it has "achieved" revenue adequacy. The ICC specifically declined to decide what period of time it may be appropriate to focus upon in determining revenue adequacy, leaving that for case-by-case determination. As to the second element of the showing required to invoke the revenue adequacy constraint, the ICC gives no indication of how it might be satisfied.

The ICC's failure to make any attempt to explain how a shipper might resort to this constraint is entirely understandable given the fact that even under the current revenue adequacy standards, it is unlikely that any railroad will be found to have adequate revenues at any point in the reasonably foreseeable future. Until realistic standards of revenue adequacy are employed, the revenue adequacy constraint is utterly useless.

(c) The Management Efficiency Constraint

The stated purpose of the management efficiency constraint is to protect captive coal shippers from bearing the costs of demonstrated railroad inefficiences. This is the ICC's claimed implementation of the Long-Cannon Amendment (49 U.S.C. § 10707(a)(e)(2)), the provision of law enacted in 1980 to protect captive shippers from excessive cross-subsidization of lower rated competitive traffic.[49] The first step in conducting this analysis is to define the extent of a railroad's revenue need shortfall, namely the difference between its actual revenues and the level of revenues deemed to be adequate under the ICC's revenue adequacy standards. This revenue shortfall can then be reduced by the amounts of revenue losses or avoidable costs which the shipper can demonstrate are attributable to the railroad's inefficiency.

The ICC decision identified three types of railroad inefficiencies which may be analyzed: operating inefficiencies, plant inefficiencies, and pricing inefficiencies. The decision does not elaborate on operating inefficiencies, but presumably an example might be a demonstration that a railroad makes a standard practice of using five locomotives to move a train where three would suffice. Presumably, the cost associated with the use of the two unneeded locomotives would be disallowed in determining the railroad's revenue adequacy.

The analysis concerning pricing inefficiencies is performed on both a short-run and a long-run basis. In order to develop the evidence required to make the necessary evidentiary showings concerning either plant or pricing inefficiencies, the shipper must conduct a cost analysis of the railroad's entire traffic base in order to identify traffic which may be moving at rates below either short-run or long-run marginal costs.

The ICC decision originally indicated that any revenue losses or avoidable costs which the shipper can establish are attributable to railroad inefficiency will be deducted from the railroads' revenue shortfall. Once the "corrected shortfall" has been established in this fashion, the shipper will be required to demonstrate that the level of differential pricing contained in the rate under challenge is more than the amount of the railroad's revenue needs which properly can be allocated to its traffic under Ramsey Pricing principles.[50] To make this showing, the shipper must analyze the demand characteristics of all of the railroad's traffic in order to determine its appropriate "share" of the railroad's revenue needs.

The complexity, difficulty, and expense of the stand-alone cost analysis are dwarfed in comparison to the effort a shipper must undertake in order to pursue the management efficiency analysis. In order to determine whether a railroad's revenue shortfall is attributable, in part, to operating inefficiencies, the shipper must (a) analyze the railroad's operations to examine their efficiency; (b) conduct a cost analysis of all of the railroads traffic in order to determine what traffic might be moving at rates which are less than short-run or long-run marginal costs; and (c) scrutinize the assets in the railroad's investment base in an effort to identify those assets which long-run marginal cost analysis indicates have lost all or part of their capacity to earn a fair return. Each of these steps individually is a massive undertaking. Each requires analysis of tremendous amounts of information, most of which is in the exclusive possession of the railroad and therefore must be sought through the discovery process. In the past, the ICC has refused to compel the railroads to provide much of the information required. In its Coal Rate Guidelines it purports to recognize that extensive discovery will be required, but at the same time it appears to impose a requirement of specificity regarding requests which may prove impossible to satisfy.

Once a shipper has completed the management efficiency analysis, as daunting as that undertaking is, it faces an even more difficult task, namely conducting a Ramsey optimal rate." In order to conduct this analysis, the shipper must present evidence concerning the demand elasticities of all of the railroad's traffic. The complainant must show that the traffic is neither underpriced, nor overpriced. The ICC consistently rejected, in the past, the railroad's efforts to impose such a requirement on shippers, because it recognized the total impracticability of such a requirement.

The cumulative effect of the burdens associated with an effort to develop a case under the management efficiency constraints is to render it entirely illusory as a remedy. The Commission has constructed an elaborate theoretical system which cannot practically be implemented. Since the Shipper bears the burden of proof, the unworkability of the system translates into a guaranteed loss for the shipper and victory for the railroad.

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[49] The three Long-Cannon factors may be summarized as follows: (1) whether the railroad is carrying traffic below cost (2) whether the railroad is carrying traffic that contributes only marginally to fixed costs, and (3) whether one commodity is bearing too much of the burden of helping the railroad achieve revenue adequacy.

[50] Ramsey Pricing is a method of differential pricing long advocated by the railroads. Under Ramsey Pricing, each rate contains a mark-up over long run marginal costs in order to cover a portion of what are determined to be "unattributable" costs (in this case, the railroad's revenue shortfall). The unattributable costs are allocated among rail customers in inverse relation to their demand elasticity. Under Ramsey Pricing, the more captive a shipper is and the less able he is to vary his demand for rail service, the greater the contribution to revenue adequacy he is required to make. In essence, Ramsey Pricing is "what the market will bear" pricing.

(d) The Phase-In Constraint

The final constraint under the ICC's Guidelines is that the ICC may require that a rate increase found to be lawful under the stand-alone cost, revenue adequacy, and mangement inefficiency analyses only be allowed to take effect in stages over some prescribed period of time in order to avoid "severe economic dislocations." The necessity for a phase-in and the type of phase-in which might be required is a matter left for case-by-case determination.

While the Coal Rate Guidelines were affirmed by the Third Circuit Court of Appeals, Judge Becker dissented from ratificaiton of the ICC's application of the Management Efficiency constraint.[51] Judge Becker stated:

> The Commission would only provide relief form the financial burden of being captive to wasteful railroad management if the demonstrated avoidable revenue loss from the inefficiency rises to the level of the railroad's entire revenue need shortfall. I find this construction arbitrary, capricious and contrary to law. . . .
>
> The Commission offers three reasons for restricting the Management Efficiency constraint in this way. First, if the inefficiency is less than the revenue shortfall, no user is harmed. Second, rate reductions for discovering inefficiencies would would only increase the carrier's costs, thereby forcing other shippers to bear a higher share of the railroad's unattributed costs through higher prices. Third, because other rail users may have been harmed by the inefficiency, it would be inappropriate to allow a single user to gain a reduction for the management inefficiencies it discovers.
>
> [Judge Becker rejected the first finding, stating that inefficiencies that increase variable costs would thus increase the price demanded by the carrier for services, despite the impact that increased price has on demand. In such circumstances, the carrier may pass on part of the cost of inefficiency to captive coal shippers. Unlike consumers of competitive services, captive coal shippers cannot shift to alternative, more efficient carriers; they can only reduce their demand. The cost of inefficiencies would therefore impact on shippers as both an increase in prive and a concommitant reduction in demand. Both constitute a harm. . . . The short answer to [the second and third] justifications is that the Commission [52] has mischaracterized the opposing views. The Commission was not requested to award a "bounty" to the identifying shipper, only to apportion a reduction in rates based on the carrier's inefficiencies to all affected shippers. By reducing rates of individual shippers only by their share of the harm, as the commentor suggests, the Commission would not shift costs or unfairly burden any shipper.[53]

Judge Becker also wrote separately to address the Stand-Alone Cost constraint, even though he affirmed its application. He stated:

> I write separately . . . to explain the serious problems of practical application that lurk beneath the adoption of the Stand-Alone Cost constraints, problems associated with litigation costs and the Commission's prescribed showing for entitlement to discovery. Excessively burdensome litigation expenses and impediments to discovery, . . . have the potential to defeat the congressional scheme by working to deny captive coal shippers meaningful access to rate review—a state of affairs that would require granting relief to the shipper-petitioners. . . . I believe that the Commission and future reviewing courts must be vigilant that the experiment does not go awry.[54]

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[51] *Consolidated Rail Corp.* v. *U.S. and ICC*, 812 F.2d 444 (3rd Cir. 1987)

[52] The Commission's view appears predicated on a mischaracterization of the argument presented in the comment of Electric Edison, Inc. [sic], to which it purports to be responding. . . . In my view, the Commission's mischaracterization of Edison Electric's proposal as a "bounty" request is pejorative and may even amount to "the arbitrary failure to give proper consideration to the core of the petitioner's claims [that] is an abuse of discretion." (Citations and some footnotes omitted.)

[53] Id. at 1458-1461.

[54] Id. at 1462.

Viewed in their most favorable light, the ICC's Coal Rate Guidelines fail to provide a meaningful measure of protection for the vast majority of captive rail shippers. The railroads have claimed that the methodology set forth in the Guidelines represents an economically rational way to regulate rates in captive markets, so as to avoid both excessive cross-subsidization and over-restriction of railroad pricing freedom. Their statements elsewhere, however, show that they really believe—ironically, along with the captive coal community—that the Guidelines in effect place no restrictions on a carrier that is considered "revenue inadequate" by the ICC. The only level of pricing prohibited under the law, they say, is monopoly pricing, and "as long as a railroad overall is not earning more than its costs [including the current cost of capital] it is not engaged in monopoly pricing." [55] Simply stated, it is the railroads' position—applicable apparently to all traffic, not just coal—that no individual railroad rate can be considered unreasonable unless the carrier is earning a current cost of capital return on its entire system. The ICC's actions to date indicate at least a general acceptance of this position. We submit this is wholly incompatible with the law.

The Commission has made much of its decisions in *Omaha Public Power District* v. *Burlington Northern*, Docket No. 38783, (served November 20, 1986) (*OPPD*), and *Arkansas Power & Light Co.* v. *Burlington Northern Railroad Company*, Docket No. 36719 et al, (served May 13, 1987) (*APL*) which resulted in shipper victories under the stand-alone guidelines to date.[56]

However, both cases involved movements along Burlington Northern track out of the Powder River Basin—which at the time faced no competition and carried an unusually large number of highly efficient unit train shipments of coal. Moreover, virtually all of the relief granted to APL remedied the rate increases BN imposed after APL signed a contract with a new competitor of the BN (and before that competitor could begin service to APL). Virtually none of the relief affected the underlying rate which had previously been in effect.[57] In addition, the rate at issue in *OPPD* was equal to nearly 250 percent of variable cost and, according to the Commission, one of the four highest rates for unit trains on the Burlington Northern system. Decision at 34. The Burlington Northern has appealed the *OPPD* decision to the Court of Appeals.

Furthermore, the *APL* decision reveals the illusory nature of the so-called management inefficiency constraint adopted in the Guidelines. In contesting one of the movements at issue in that case, APL calculated that the BN could have reduced its revenue need by hundreds of millions of dollars from 1981 through 1983 along.[58] If these figures were applied, the Burlington Northern would be revenue adequate in 1983.[59] However, the Commission avoided having to reduce rates under the management inefficiency constraint in two ways. First, it applied the management inefficiency constraint over a number of years.[60] Second, it refused to allocate to APL any share of the harm of the extensive management inefficiencies which APL had demonstrated, based on a determination which Judge Becker had criticized in his opinion regarding the Coal Rate Guidelines. In so doing, it eliminated any incentive for railroads to reduce inefficiencies.

The Commission's treatment of the third Long-Cannon factor—whether one commodity is paying an unreasonable share of overall revenues—virtually reads that factor out of the Act. The Commission's discussion of this issue states:

> APL complains that coal revenues accounted for a substantial portion (90 percent in 1982 and 50 percent in 1983) of BN's net system revenue (i.e., revenue exceeding system variable cost) compared to coal's percentages of gross revenues (25 and 37 percent, respectively, for 1982 and 1983) and total system car loads (41 and 42 percent in 1982 and 1983).
>
> However, as we explained in *Guidelines*, a disproportionate share is not necessarily an unreasonable share of revenue needs. Thus, whether a shipper is paying an unreasonable share of the railroad's revenues cannot be

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[55] "AAR's Comments on EEI's 19 Cases of Alleged Railroad Ratemaking Abuses," submitted December 9, 1985 to Subcommittee on Fossil and Synthetic Fuels, U.S. House of Representatives, at 14.

[56] A rate reduction for the City of San Antonio recently ordered by the Commission is based upon a unique provision of the Staggers Act applicable only to San Antonio.

[57] Docket 36719 et al, *Arkansas Power & Light Co.* v. *Burlington Northern Railroad Co.*, Decision served May 13, 1987, at 3.

[58] Id. at 11, note 29.

[59] Id. at 10; Vice Chairman Lamboley dissent, at 23a.

[60] Id. at 10.

> determined merely by examining its percentage contribution above RFA variable cost.[61]

Given the Commission's position, particularly with respect to 1982 activities, we doubt the third Long-Cannon factor would ever be applied.

Finally, application of the stand-alone cost threshold does not constrain rates where the stand-alone cost level falls below the jurisdictional threshold. In both OPPD and APL, the stand-alone cost of certain movements fell below the jurisdictional threshold, and relief could not be made below that threshold level.[62]

(f) The Consumer Rail Equity Act Will Re-Establish the Balance of Interests Intended by Congress

The Consumer Rail Equity Act maintains the Staggers Act requirement that a rate must involve a captive shipper and must exceed the jurisdictional threshold to invoke ICC rate reasonableness authority. After such a showing is made, however, it shifts the burden of proof to the party possessing all of the data—the market dominant railroad. The Act also prescribes a set of factors to be considered in determining maximum reasonable rates. Specifically, Section 4 of the Act:

> requires analysis of a carrier's revenue needs, in terms of the extent to which such needs require pricing captive traffic at differential pricing levels in excess of those inherent in the jurisdictional standards of current law;
>
> requires that the ICC analyze the relationship between a challenged rate and the cost of providing the rail service; and
>
> ensures that the shipper-protective elements of the Long-Cannon Amendment will be considered in all maximum rate determinations.

Contrary to the railroads' claims, Section 4 of the Act does not cap rates at the jurisdictional threshold. Shippers must demonstrate that the rate exceeds the threshold and that they are captive, before the ICC takes jurisdiction. Only if such showings are made does the railroad—which controls the relevant data—have the burden of proof placed on it. Furthermore, the standard of Section 4 fully respects the principle of differential pricing and allows the ICC to consider demand. The ICC retains considerable flexibility. True to the spirit of balance which infused the legislative process in 1980, however, the standard recognizes some clear limits on differential pricing for captive traffic, and acknowledges the time-tested validity of considering the actual cost of service as one of several elements in a rational ratemaking policy.

3. The ICC Inflation Index

(a) Accurate Costing

An issue of critical concern to both railroads and shippers in the Staggers Act involved the establishment of procedures that would permit the railroads to recoup, automatically and without possibility of challenge through their freight rates, cost increases they incur due to inflation. Prior to the Staggers Act, the railroad industry would periodically come before the ICC in so-called "general rate increase proceedings" and request across-the-board increases in rail freight rates in order to recoup, inter alia, cost increases due to inflation. Given the inflationary spiral which hit the United States in the late 1970's, general increase proceedings became more and more frequent and the costs of processing these cases dramatically increased. Under this system, the railroads were continuously exposed to a regulatory lag between increases in their costs due to inflation and approval of general rate increases to cover such costs.

In the Staggers Act, Congress prescribed a method for dealing with the cost inflation/rate pass-through problem. Pursuant to Section 203 of the Staggers Act, the ICC was called upon to devise an index which measured railroad cost increases due to inflation.[63] The railroads are permitted, on a quarterly basis, to increase their freight rates by the percentage change in this ICC index. Because the purpose of these rate increases is merely to offset increases in costs, they are shielded from challenge by shippers.

While the cost recovery rate increase concept is sound, in 1981 the ICC adopted an inflation index (which is referred to as the Rail Cost Adjustment Factor or RCAF) which overstates the railroads' cost increases. The effect of such overstatements is to shield the railroads from any possibility of challenge to rate increases which exceed the amount necessary to recover cost increases. If the cost recovery rate identifies cost increases accurately, the railroads may still increase rates above the level permitted by the index, but such additional increases are subject to challenge as being unreasonable, if the rate is otherwise within the ICC jurisdiction.

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[61] Id. at 12.

[62] Id. at 22; Docket 38783, *Omaha Public Power District* v. *Burlington Northern,* Decision served November 20, 1986 at 16, N.25.

[63] 94 Stat. 1901–02.

The principal problem with the index—which was promulgated by the ICC in its *Ex Parte No. 290 (Sub-No. 2)* proceeding [64]—is that it measures only changes in the prices railroads pay for goods and services (input prices), and does not take into account the acknowledged effect of productivity changes which have reduced the railroads' cost of producing services (output).[65] For example, if prices paid by the rail industry for fuel increased 20 percent, the ICC's cost recovery index would rise accordingly, even if the industry were moving twice as much freight per gallon of fuel so that actual output costs per unit of output had not risen but fallen.

While the United States Court of Appeals for the D.C. Circuit affirmed the ICC's 1981 decision in *Ex Parte No. 290 (Sub-No. 2),* it noted that the ICC should adopt a productivity adjustment if a valid adjustment could be formulated.[66] On July 26, 1982 the ICC instituted an investigation entitled Ex Parte No. 290 (Sub-No 4), *Railroad Cost Recovery Procedures-Productivity Adjustment.* In comments filed on October 25, 1982, shippers provided specific standards for measuring rail productivity and for adjusting the Rail Cost Adjustment Factor. Almost two years later, following a shipper motion for extraordinary relief and subsequent August 30, 1984 order from the Court of Appeals for the D.C. Circuit requiring from the ICC a status report on this matter, the ICC issued a "Notice of Proposed Rulemaking" on September 27, 1984. In that notice, the ICC asked for "additional comments," including "comments on whether a productivity adjustment should be made at all." Although EEI and other rail shippers again filed extensive comments, at this point over two and half years have passed and the ICC has taken no further action. Last year, Chairman Gradison's February 21, 1986 written statement to this Subcommittee merely indicated "[T]he Commission is currently considering the feasibility of adding productivity to the RCAF Formula." As recently as March 20, 1987 Vice Chairman Lamboley urged Commission action, stating:

> I do not believe we can continue to ignore the productivity factor. When computing these quarterly adjustments [to the inflation index]. When input price indices are used for regulatory purposes, they should be adjusted to incorporate changes in productivity.[67]

Nevertheless, the ICC is still questioning whether a productivity adjustment should be made at all. While the ICC waits, and contemplates, shippers continue to be overcharged for cost increases because of the ICC's failure to accurately reflect increases in railroad costs.

The railroads themselves have acknowledged significant improvements in productivity in recent years. The AAR discusses productivity improvements in Section IV of its November, 1986 publication, *The Coal Book.* Section IV states, for example, (at 36):

> Almost every measure of productivity has shown significant improvement.
>
> . . . Since, 1970, the total number of open-top hopper cars—the type of car most often used to move coal—has dropped by more than 25 percent. . . . Yet railroads move one-third more coal than they did then, and with no car shortages.
>
> . . . Today's freight cars perform almost 80 percent more work on each trip than they did just a decade ago.

In comparison to the ICC's dilatory approach, the Railroad Accounting Principles Board has quickly and decisively identified the need for a productivity adjustment to the RCAF in order to account for changes in input level as well as changes in unit costs. The Exposure Draft of Railroad Accounting Principles which the Board issued on February 20, 1987 finds that "The Productivity Principle requires that cost-based indices measure both change in price and change in productivity."[68] The Exposure Draft also states:

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[64] Ex Parte No. 290 (Sub-No. 2), *Railroad Cost Recovery Procedures,* 364 I.C.C. 841 (1981); modified in a decision served October 6, 1986.

[65] "Productivity" as used in this decision simply means the efficiency with which inputs (labor, material, etc.) are used to produce outputs. A productivity increase—i.e., an increase in the amount of output produced by the same inputs, or a reduction in the inputs required to produce the same output, or a combination of the two—can result from a number of different sources, including technological changes, changes in input or output mix, and volume increases.

[66] *Western Coal Traffic League* v. *United States,* 677 F.2d 915 (D.C. Cir.), cert. denied, 459 U.S. 1086 (1982).

[67] Ex Parte No. 290 (Sub-No. 2), Railroad Cost Recovery Procedures, served March 20, 1987, at 3.

> The RAPD has reviewed information regarding several models, and is convinced that practical productivity methodologies exist that, when used in combination with input price indices, will yield economically accurate measurements of costs changes.[69]

Finally, the Exposure Draft states: "The RAPB recommends the use of presently available methodologies to measure and incorporate productivity. . . .[70]

The Board's ability to address and recommend solutions to assure the accuracy of the RCAF is in marked contrast to the ICC's delay.

Unless the principles articulated in the Board's Exposure Draft are implemented and productivity is taken into account in the context of the price index used to compute the RCAF, the RCAF will continue to overstate increases in railroad costs. Captive shippers will not be able to challenge increases which result in unreasonable rates and are not truly cost based. It also exaggerates the impact of inflation on rail costs. In this regard, the ICC's action, or more properly lack of action, reveals consistency with its other practices identified above—the result serves to exaggerate railroad costs.

(b) Cost Declines

Another distinct problem with the ICC's methodology was that it only allowed rates to increase. Thus, when rail costs went up—so did the rates. But when rail costs went down, no corresponding downward rate adjustments was required.

Furthermore, the ICC's methodology was based on projections of what costs would be in the coming quarter. If those projections were too high and rail costs subsequently went down or increases did not materialize, there was no mechanism to remedy, for the following quarters, the effects of the excessive projection. On December 20, 1985, the ICC approved a 1.1 percent increase in rates, based in part upon a December 5, 1985 railroad projection that costs for fuel (primarily oil products) would increase 4.9 percent from the actual fourth quarter 1985 level to the first quarter of 1986. This determination was made notwithstanding shipper submissions which showed that the railroads' December 5 filing was based on stale data and that more recent projections anticipated that fuel prices would actually decline, particularly in light of the failure of the December 11, 1985 OPEC meeting to reach an agreement on price or marketing strategy. The AAR's March 5, 1986 filing with the ICC confirmed that rather than increasing 4.9 percent, fuel prices, by February 26, 1986, had decreased approximately 33 percent from the actual fourth quarter level. It became very clear, therefore, that tariff shippers experienced charges which were based upon an erroneous assumption. Under the initial RCAF methodology the effect of this erroneous assumption would continue due to the failure of the ICC to make downward adjustments in tariff rates when its index declines.

In response to widespread criticism last year, the ICC made some necessary changes and adopted rules in October, 1986, to provide a mechanism to correct for forecast error and to require tariff rates to decline when the RCAF declines.[71] However, some railroads are appealing the ICC decision.

(c) The Consumer Rail Equity Act Solution

Section 6 of the Consumer Rail Equity Act would quickly and effectively address the problems with the ICC's inflation adjustment mechanism without interfering with the Staggers Act's mandate for prompt, accurate rate adjustments to offset changes in railroad costs. Section 6 directs the ICC to take productivity changes into account. It also confirms the Commission's authority to mandate rate reductions (but only to the extent of prior increases) in those cases where railroad costs—as reflected in the ICC's index—decline. The bill also requires the Commission to recompute the index to adjust for all cumulative forecast error. None of these changes restrict the railroads' ability to increase rates above the levels permitted by the cost recovery index—they merely have the effect of allowing such additional increases to be subject to challenge if the movement is for a captive shipper and the rate exceeds the jurisdictional threshold.

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[68] Exposure Draft, Railroad Accounting principles Board (February 20, 1987) Vol. 2, at 114.

[69] Id. at 17.

[70] Id. at 53.

[71] *Railroad Cost Recovery Procedures*, Ex Parte No. 290 (Sub-No. 2), served October 17, 1986. Commissioner Andre dissented. Railroad requests for a stay of this decision were denied by the ICC, the Court of Appeals and the Supreme Court.

CONGRESS MUST ACT

The electric utility industry supports the fundamental goals of the Staggers Rail Act, and believes that in a great many areas, the Staggers Act has worked well and has been implemented by the ICC in such a manner as to carry out the intent of Congress. We wish to make it clear to this Subcommittee that we stand firmly opposed to any effort to "turn back the clock" or otherwise drastically change the reform legislation enacted in 1980.

Despite the many successes, however, there remains one glaring failure under the Act: the ICC's indifference to the plight of captive shippers of bulk commodities, and its continuing failure to give adequate effect to those provisions of the Act designed by Congress to protect such shippers. Coal users and the consumers they serve have been the principal victims of the Commission's interpretations and applications of the law.

The ICC continues to stall attempts to correct the RCAF to determine costs accurately; it retreated from many proposed changes necessary to its revenue adequacy standards and it continues to overestimate railroad investment base by adding $7 billion to the investment base through an accounting technicality. Most rate cases still remain to be decided.

The evidence makes it clear that neither Congress nor captive shippers can afford to continue to "wait and see." While a comprehensive overhaul of the Staggers Act is neither required nor desirable, there remains no alternative but legislative action to ensure future enforcement of captive shipper protections, and to achieve the balance approach to railroad rate regulation which Congress so clearly mandated in 1980.

To accomplish this goal, we strongly urge action by this Subcommittee and the Congress to enact S. 676, the Consumer Rail Equity Act, and rectify the manner in which the Interstate Commerce Commission has implemented the Staggers Rail Act captive shipper protections.

We appreciate the opportunity to present the position of the Edison Electric Institute on this important consumer issue before the Subcommittee.

CONRAIL,
June 10, 1987.

Hon. JOHN D. DINGELL,
Chairman, Committee on Energy and Commerce, U.S. House of Representatives, 2221 Rayburn House Office Building, Washington, DC.

DEAR MR. CHAIRMAN: At the June 2 hearing held by the Subcommittee on Transportation, Tourism and Hazardous Materials, you questioned Ms. Gradison as to why Conrail did not state in its prospectus that it was "revenue inadequate" for purposes of regulation by the Interstate Commerce Commission (the "ICC"), and asked whether this might be a securities law problem.

The term "revenue adequacy" is term-of-art coined exclusively for regulatory purposes. The Securities Act of 1933, as amended, and the rules and regulations promulgated thereunder by the Securities and Exchange Commission contain detailed requirements for the disclosure of financial information by a company in its prospectus. Conrail made all these required disclosures in its prospectus; indeed, Conrail made more than the required disclosures by including six years of financial information instead of five.

Conrail also included in its prospectus an extensive discussion of regulation by the ICC, and specifically mentioned that its earnings potential could be materially adversely affected by ICC regulation and by efforts to change the Interstate Commerce Act.

From an investor's viewpoint, the appropriate concern is not the ICC finding of "revenue inadequacy", but rather the potential adverse impact on Conrail and its earnings if the ICC were to find Conrail "revenue adequate" because of the loss of rate-making flexibility that would result from such a finding. Investors were, as noted, provided with substantial information on which to base their investment decision regarding earnings, traffic levels, and other financial data.

Conrail's treatment of its status as "revenue inadequate" for ICC purposes is consistent with the treatment by other railroads of their status as "revenue inadequate". To the best of Conrail's knowledge, no railroad has included a statement in any of its filings under the Securities Exchange Act of 1934, as amended, (which contains the same disclosure requirements as the Securities Act of 1933, as amended, with respect to matters affecting a company's financial well-being) to the effect that it is "revenue inadequate" for ICC purposes.

I hope that this clarifies Conrail's position as to the accuracy of its prospectus in this regard.

Sincerely,

William B. Newman, Jr.
Vice President.

U.S. House of Representatives,
Committee on Energy and Commerce,
Washington, DC, June 15, 1987.

Mr. William B. Newman, Jr.,
Vice President and Washington Counsel, Consolidated Rail Corporation, Washington, DC.

Dear Bill: Thank you for your letter of June 10, 1987, regarding my questions to Heather Gradison involving Conrail's public offering prospectus at the June 2nd ICC oversight hearing.

My questions, as I am sure you understood, were entirely rhetorical in nature. I do not believe that the omission of any reference to Conrail's "revenue inadequacy" in the prospectus poses any securities law problem at all, for the simple reason that immaterial facts need not be disclosed in a prospectus.

My questions to Chairman Gradison illustrated how the concept of revenue adequacy, as developed and applied by the ICC, has been used to protect exorbitant rates charged by railroads to captive shippers even while the rest of the world pays no attention to the measure at all in assessing a railroad's financial health. Your comments regarding other railroads' omission of their revenue inadequate status in SEC filings confirms my views.

Indeed, your letter illustrates the ironic and even bizarre situation in which we find ourselves with respect to this issue. You point out that "[f]rom an investor's standpoint, the appropriate concern is not the ICC finding of 'revenue inadequacy,' but rather the potential adverse impact on Conrail and its earnings if the ICC were to find Conrail's 'revenue adequate.' " I find this most troubling, since 49 U.S.C. 10704(a)(2) provides that a finding of revenue adequacy should indicate, among other things, the ability to raise, attract, and retain needed capital, including equity capital. There could be no greater testament to the need for reform of this flawed concept than the perverse effect that you acknowledge a revenue adequacy finding would have in the real world. I appreciate your bringing it to my attention.

Sincerely,

John D. Dingell,
Chairman.

Keystone Bituminous Coal Association

JOHN C. SHIRVINSKY
PRESIDENT

June 15, 1987

The Honorable John D. Rockefeller
United States Senate
Washington, D.C. 20510

Dear Senator Rockefeller:

The Keystone Bituminous Coal Association (KBCA) would like to thank you for your leadership in sponsoring the Consumer Rail Equity Act now before the Senate Surface Transportation Subcommittee, on which you serve, and offer some observations on the grave situation faced by coal producers in Pennsylvania. The KBCA is a non-profit association which is comprised of companies that account for about 50 percent of the total bituminous coal production in Pennsylvania, including more than 85 percent of the state's deep mine production.

In terms of manpower, the KBCA represents the employers of approximately two-thirds of the men and women working in the bituminous coal fields of Pennsylvania. We are experiencing severe problems characterized by the fact that during the past decade, Pennsylvania's bituminous coal production has experienced an alarming decline of 31 percent. The state's bituminous coal employment figure has been cut in half during the past seven years. In 1978, 39,000 men and women were employed in Pennsylvania's coal mines; however, by 1985 fewer than 20,000 persons were so employed. In southwestern Pennsylvania, where most bituminous coal mining is conducted, coal unemployment is almost 50 percent, a tragic circumstance.

Clearly, the delivered priced of coal, including the price at the mine and the rate charged for transportation, is the principal factor governing coal's competitiveness in domestic and export markets. With that in mind, our coal producers have taken steps to increase productivity at the mines, such as the utilization of long-wall mining equipment in deep mines and high capacity draglines at surface mines. Such measures have caused great improvements in productivity at the mine, resulting in improved competitiveness from a coal supply perspective. Yet we are concerned that another component of coal's delivered price, railroad rates, are not similarly being set at competitive levels even though rail carriers have been increasing their productivity by a substantial amount.

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In 1985 more than 25 million tons of bituminous coal produced in Pennsylvania were shipped by railroad, and 40 percent of that coal traffic was delivered to customers also located in the state. Obviously, Pennsylvania's coal producers and consumers must rely heavily on efficient, reasonably-priced railroad services to enable full utilization of such coal in various energy markets. We are highly concerned about the failure of the Interstate Commerce Commission to administer railroad regulation during the 1980's in a balanced manner specified by the Staggers Rail Act of 1980, a failure exemplified by the Commission's adoption of railroad rate and revenue standards which do not protect captive shippers from rate abuses.

In light of the serious drop in the production of bituminous coal in Pennsylvania in recent years, notwithstanding abundant reserves available in the state, and realizing that the bituminous coal producers have acted responsibly by implementing measures to improve productivity and enhance the competitiveness of Pennsylvania's bituminous coal, we must now seek to overcome the problematic administration of railroad regulation by the Commission through passage of the Consumer Rail Equity Act. The legislation simply would enforce the requirement that captive shippers be afforded protection from abuses in railroad rates and service already established by the Staggers Rail Act, but negated by failure of the Commission to act responsibly in the regulatory process.

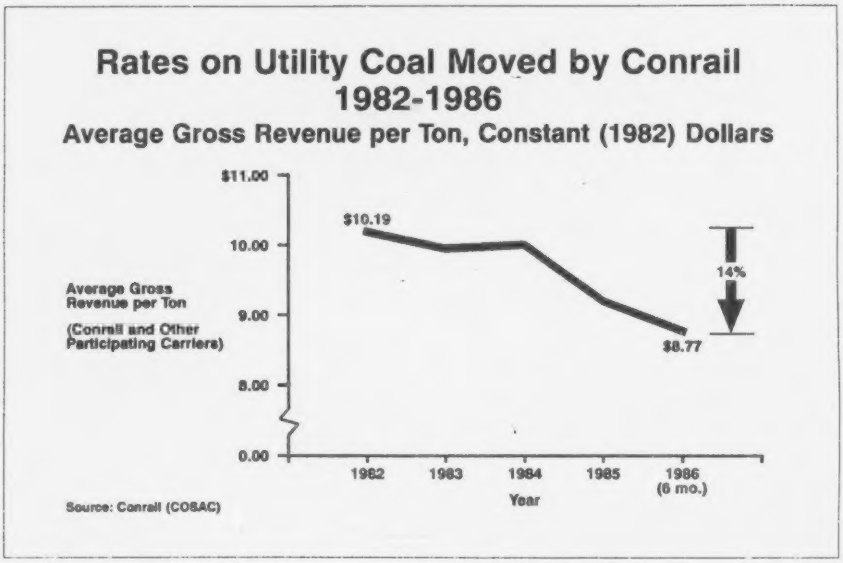
In closing, the KBCA commends you for sponsoring the Consumer Rail Equity Act, legislation urgently needed to arrest the devastating decline in utilization of bituminous coal produced in Pennsylvania, as well as to ensure that our abundant coal reserves and our competent, yet underutilized, coal mine work force will recover from the present crisis in Pennsylvania bituminous coal fields.

Sincerely,

John C. Shirvinsky

John C. Shirvinsky

EXHIBIT "A"



Rates on Utility Coal Moved by Conrail 1982-1986

Average Gross Revenue per Ton, Constant (1982) Dollars

Source: Conrail (COSAC)

EXHIBIT "B"

Here's another example. Metropolitan Edison's Titus generating plant at Reading, PA is served only by Conrail. Last year Met Ed opted to close the plant and purchase electricity from Philadelphia Electric. Question: Is Met Ed a "captive shipper"? No, because is has clear alternatives. This is hardly a unique situation: in an era of chronic oversupply of power, most utilities have available similar make-vs.-buy options at reasonable cost.

The point of these examples is simple: There are far fewer "captive shippers" than CURE and its allies would have you believe. Yes, there are many power plants, coal mines, and other customers who are served by only one rail carrier. But this is not the same as having no options. Most of these customers do have clear alternatives, both transportation and non-transportation, and they are willing to use them if a railroad attempts to charge unreasonable rates. And it is precisely this knowledge which keeps rail rates in line. Staggers is clearly right in taking these "non-transportation" options into account in evaluating cases of alleged market dominance.

STATE OF SOUTH DAKOTA
EXECUTIVE OFFICE
STATE CAPITOL BUILDING
PIERRE, SOUTH DAKOTA 57501

GEORGE S. MICKELSON
GOVERNOR

(605) 773-3212

June 24, 1987

The Honorable Larry Pressler
United States Senate
407 Russell Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Pressler:

I am writing to you regarding the Consumer Rail Equity Act which has been introduced in Congress as S. 676 and H.R. 1393. It is my belief that this legislation is not in the best interest of south Dakota's rail system or its shippers, and I ask that you not lend it your support.

The Staggers Rail Act of 1980 made fundamental changes in the rail industry in response to the industry's serious financial problems and declining competitiveness. Today, railroads are using their improved financial strength to reinvest in long-neglected track and equipment and to compete more aggressively in the marketplace. Contract rates and tariff rate flexibility are two of the tools which have greatly improved the ability of railroads to meet the needs of their customers. Legislation passed in the 1970s provided railroads with important sources of financial assistance, but not until the Staggers Act freed the industry to respond to changing markets and earn a rate of return that permits re-investment, did railroads begin to address their financial crisis.

In addition to assisting the major railroads, deregulation has been a major factor in the formation of short lines and regional railroads. These new carriers have preserved service on many lines that would otherwise have been abandoned or downgraded. The Dakota, Minnesota and Eastern Railroad in South Dakota would probably not exist if the Staggers Act had not been enacted. Similarly, Burlington Northern's service on the South Dakota Main Line and Core System has been much more effective than it would have been in the pre-Staggers era. Very simply, the Consumer Rail Equity Act would reverse key portions of the Staggers Act and restore regulatory provisions that would cause rail service to deteriorate, rates to increase, and traffic to decline. The obvious effect is more unprofitable trackage that is abandoned.

I understand that, during hearings on this legislation, representatives of rail labor urged Congress to mandate that labor protection be provided in the event of sales of track to new short line and regional carriers. At present, the Interstate Commerce Commission does not require labor protection when lines are sold to non-carriers (companies entering the rail industry for the first time). This policy favors the acquisition and operation of lines by smaller railroads which can utilize a lower cost structure to preserve service on lines that might otherwise be lost. Because labor typically represents 50 percent of a large railroad's operating costs, the ability of smaller railroads to reduce these costs is essential to their success. The formation and success of short lines is clearly in the public interest, and I urge that you not support efforts to impose labor protection where it is not currently required by the ICC.

Because these issues are vitally important to South Dakota and its rail system, I request that you provide this letter to Senator Exon for inclusion in the hearing record.

Thank you for considering my views on these legislative proposals. As always, I look forward to working with you on issues important to South Dakota.

Very truly yours,

GEORGE S. MICKELSON

GSM:crj

QUESTIONS OF THE CHAIRMAN AND THE ANSWERS

1. As you know, under current law, a shipper who challenges a rail rate has the burden to prove the unreasonableness of the rate. Critics of this argue that this disadvantages shippers, since the railroads have access to all of the essential information in rate cases. What is your reaction to the proposal embodied in S. 676, that the burden of proof for rate reasonableness be shifted to the railroads?

As I indicated in my testimony, this provision of the CURE bill would reverse a fundamental tenet of administrative law that, in the case of ICC proceedings, dates back well before the 4R Act of 1976. Shippers have always had the burden of proving that an existing rate (i.e., a rate under which they had been shipping) is unreasonable. Conversely, railroads have traditionally had the burden to show that proposed rates, and rate increases, are reasonable. The basis for these principles is logic and fairness -- it is up to the party that wants to change an existing practice to show why that change should be made. The Staggers Act did not alter these principles, except to require that a shipper bear the burden if it is challenging a rate increase that falls within the statutory zone of ratemaking flexibility for cost-based increases.

Moreover, it is not apparent from the record that shippers have had major difficulties in finding evidence on which to make their cases. The first case under the Coal Rate Guidelines, Omaha Public Power District v. Burlington Northern Railroad, was decided in favor of the shipper, and several more have followed. In fact, I believe that to date, shippers have won more rate reasonableness determinations at the full Commission level than have the railroads.

The CURE proposal would be an invitation to some shippers to file frivolous rate complaints, tying up the ICC with needless paperwork and then sitting back to watch the railroads defend their entire rate structures. It is just another part of the bill that would result in more, not less, regulation and regulatory delay.

And before it could arrive at any decisions under the new bill, the ICC would have to undertake rulemakings to develop new maximum rate guidelines. It has taken nearly 10 years of effort for the Commission to develop standards that can satisfy legal and economic principles and stand up in the courts. The requirement in the CURE bill for the ICC to develop new maximum rate standards would delay resolution of all the pending maximum rate cases for a year or more, with no guarantee that legally justified and economically efficient ratemaking principles would be established.

2. A representative of the National Industrial Transportation League has testified that its members have placed an increasing emphasis on "competitive access" issues since passage of Staggers, and for this reason, the League supports the development of legislation in this area. How do you view the problems that may exist in the competitive access area?

"Competitive access" is probably the most complex and difficult issue in the Staggers Act debate. It was clear to anyone looking at a routing guide in the 1970s that railroads offered far more routing options than could be used fully and effectively. They could not lower costs and provide efficient service if they were required to maintain countless routes between the same two points. But until 1980, the regulatory system worked to block even the most rational restructuring of routes and to keep rates equalized, so the same rate applied to all competing routes, regardless of the relative cost to the railroads to provide service on each route.

The combination of the Staggers Act requirement to eliminate collective ratemaking and the flexibility to cancel joint rates, which was provided in the Act and a parallel interpretation of a previous statutory provision, allowed railroads to restructure their routes and rates after 1980 to be able to emphasize efficiencies and compete on the basis of price. We recognize that this process created concern and confusion among shippers and carriers. In the rush to overhaul route structures, shippers and connecting carriers often were not consulted, or even notified. Nevertheless, FRA staff research indicates that at most only about 4 percent of rail traffic (based on 1980 levels) appears to have been affected by routing cancellations.

I believe that the agreement on competitive access reached between the Association of American Railroads and the National Industrial Transportation League in 1985 and adopted by the ICC as part of its formal regulations represents a balanced approach to the regulation of competitive access. It allows railroads to restructure routes to take advantage of efficiencies and lower costs, but also protects shippers from actions that would eliminate competition. I understand that since the new regulations have been in place, many joint-line routes and rates have been established or reinstated through negotiated agreements that satisfy both railroad and shipper interests.

In contrast, the competitive access provisions of the CURE bill would remove not only the railroads' but also the ICC's discretion to review market circumstances and all other considerations in determining whether or not a particular joint rate or other access option is appropriate.

The bill would prevent the Commission from distinguishing the cases in which competitive access would serve the public interest from those in which the effect would be precisely the opposite. It makes no more sense to mandate additional access in every case than to bar competitive access in every case.

One provision of S. 676 would make it mandatory for the Commission to order reciprocal switching, terminal trackage rights, and establishment or preservation of joint rates and routes, where today the authority is discretionary. There are cases where the future volume of rail traffic may be sufficient to sustain multiple carriers, and introduction of a second railroad can result in efficient and attractive service and rates. The Powder River Basin in Wyoming is the best example; in that situation, the total volume of freight is very high and has continued to grow since entry of a second railroad. Both carriers in the Basin have been able to operate efficiently and profitably in direct competition with each other. On the other hand, where volumes are not large and have little potential to grow, adding an additional carrier would simply mean that a small traffic base would be further diluted. One more carrier would have to run trains to the same points and shippers, with the associated expense of equipment and crews, adding to the total costs of serving the lines. Thus, by dividing the same amount of traffic among multiple carriers, the unit costs of rail service would increase. That would either force up rail rates or force down rail earnings and deny the carriers the revenues necessary to maintain plant and equipment and sustain the quality of service. Neither outcome would serve the railroads' customers.

In addition, under the CURE bill, if the carriers involved in a competitive access case for trackage rights or reciprocal switching could not agree on the level of compensation to be paid for the access, the ICC would be required to set the fees, according to statutorily prescribed standards. The bill would constrain the fees to be no higher than a particular formula. The mandated fee levels would not only threaten to deny railroads adequate compensation, but could also produce additional inefficiencies in resource use, by encouraging traffic to be routed in accordance with prices unrelated to the overall capital and operating costs involved.

S. 676 would also require a railroad, at the request of a shipper, to establish a rate for a joint-line routing pegged to the rate on the lowest cost single-line route between the same two points. Again, where traffic densities in the corridor involved are too low, the joint routings are not efficient, or there is already vigorous competition from other modes, it may not serve the public interest to require additional rail options to be introduced or preserved. Such a policy would encourage a return to the pre-1980 practice of maintaining multiple and often redundant routings between two points, with all the attendant costs of duplicative investments in track and operations, when handling the traffic on fewer, higher density routes would permit lower costs and lower rates to shippers.

The bill would promote a structure of rates equalized at the rate-to-variable cost ratio represented on the single-line route between the two points involved. If the single-line route had substantially lower variable costs than any other route, the proposal might not actually lead to any significant use of competing routes, but only restrict the carrier's and the ICC's discretion to establish efficient, market-sensitive rates. However, if several competing routings had similar variable costs--though not necessarily similar fixed or total costs--the CURE bill could force railroads to charge comparable rates on all of those routings and divide traffic among them, thus incurring a higher level of overall costs for operations, maintenance, and investment. The result might well be higher rates on all the routings, to allow recovery of the costs on the least efficient routes.

Thus, while CURE's competitive access provisions could drive railroads to lower some rates in the short run to meet the new statutory standards or to try to build traffic levels, in the long run, the effect would be costly to shippers and carriers. And in the short or long run, the provisions would reduce an individual railroad's ability to make the most efficient use of its plant and equipment and to offer the most competitive combination of rates and services to its shippers.

Forcing a company to permit use of its own property at prescribed rates, particularly in order to allow a competitor to vie for the business, is undoubtedly one of the most intrusive actions the government can take against a private business. In the guise of attempting to create and maintain intrarailroad competition, the CURE bill and other similar proposals threaten a radical restructuring of the physical nature and operation of the rail system, and a reversal of the Staggers Act policy to minimize reliance on government interference in resolving issues between railroads and shippers. We believe this would be an ill-advised and unjustified step. Ultimately, it would be destructive to the progress the railroads have made since 1980 in becoming more efficient and competitive participants in the national transportation system. When circumstances and the most effective means for addressing them differ so widely between individual cases, the regulatory agency must be given the discretion to develop solutions that will best meet the public interest in the particular situation. Removal of that discretion would hurt the very shippers that competitive access was intended to help.

3. You have expressed the opinion that improvements in rail-related facilities and in the industry as a whole are directly attributable to the success of the Staggers Act. To what extent do you believe favorable tax treatment for the railroads contributed to these investments, and how do you feel this may be affected because of the loss of these benefits and changes in the tax laws?

As the railroads themselves have testified, they along with other capital-intensive industries benefited from the 1981 Tax Act. The depreciation and leasing provisions of that legislation added to the railroads' cash flow, giving them additional dollars to invest. But had it not been for the regulatory reform represented by the Staggers Act, it is doubtful that many of those additional dollars would have been invested back into the rail industry. The ratemaking flexibility represented by the Act gave the carriers the means to try and earn an acceptable rate of return, by tailoring service to meet the competition. Without that flexibility, significant investment in the rail industry would not have been wise from a financial perspective, and simply would not have occurred. The new changes in the tax laws will remove some of the short-term benefits for capital-intensive industries, but we believe the more important issue is to retain the long-term incentive and ability to invest provided by the Staggers Act reforms.

4. You have testified that in constant dollar terms and since the passage of Staggers, average grain rates are down 28 percent and average coal rates have declined 5.9 percent. To what do you attribute this difference between coal and grain rates?

There are many reasons why the rate of decline in grain and coal rates has been different since 1980. One has to do with the nature of the two markets. The volume of railroads' total grain traffic declined 20 percent from the record in 1980 through 1985 (as has grain traffic moving by barge), with the slackening of the export market. The railroads have made use of the Staggers Act flexibility to lower rates on grain to try to retain as large a share of their market as possible. In contrast, even though the export coal market has declined, domestic coal shipments have been increasing. Overall railroad tonnage of coal has remained fairly stable since the Staggers Act. Thus, the market conditions affecting pricing for grain and coal have been different.

But a more important factor may be that the nature of grain transportation has changed significantly since 1980. Unit train shipments, used in the Corn Belt states east of the Mississippi before the Staggers Act, have become prevalent in the corn and wheat areas west of the Mississippi. Single-car transit rates, which were very common in the wheat growing regions, have been replaced by multi-car and unit train services from terminal elevators. These latter types of services are much more cost-efficient for the carrier, and those savings have been passed on to the elevators and the producers.

In contrast, the changes in the technology used for handling individual movements of coal have not been as dramatic or as widespread in the years since 1980. The major shift of large volume utility movements into unit train service occurred before 1980, so the impact of that shift does not appear in post-Staggers data on individual rates. New unit train movements continue to be introduced but they generally do not affect the level of rates charged on pre-existing traffic, the focus of the rate statistics. In the Eastern coal regions, much of the coal traffic still moves from small mines, where the volumes and the terrain limit the feasibility of unit train shipments, so many movements continue to be handled as single-car or small multi-car operations from the minehead. Therefore, the opportunities to shift to an entirely new type of service, cut costs, and pass the savings along to shippers have not been as extensive in coal transportation as in grain.

5. If the Consumer Rail Equity Act were enacted, how do you feel it would affect the workload of the ICC, as well as the handling of rate cases pending before the Commission?

The CURE bill would have an immediate and dramatic effect on the workload of the Commission, because it would re-regulate rail rates and services that are now determined by competition, and invite an avalanche of new cases to the ICC. That could only further strain the resources of the Commission and exacerbate the problem of delays in obtaining decisions.

- Changing the burden of proof for rate reasonableness is an invitation to shippers to file automatic rate protests, even when not justified, thereby increasing the number of cases that must be reviewed by ICC staff.
- Artificially expanding the definition of a captive shipper by prohibiting consideration of product and geographic competition would increase the number of rate reasonableness cases the Commission must resolve.
- The competitive access provisions of the bill would dramatically increase the number of access cases at the Commission because the provisions require ICC action simply on request of a shipper or connecting carrier. In addition, because evidence of intermodal competition could not be considered, the bill would require the Commission to set rates and/or access fees in situations now considered to be protected by the marketplace.
- Returning to the pre-Staggers Act environment for intrastate regulation would mean a return to an endless series of appeals of state regulatory decisions at the ICC.
- In addition to the increased workload resulting from these individual cases, the Commission would also be required by the bill to undertake a massive investigation each year to closely examine all of each carriers' marketing and pricing decisions, to determine if management is setting rates on competitive traffic to optimize revenues.

The bill's effect on pending cases may depend on the stage of the case. For some cases, the bill could even mean that the Commission would have to go back and review the docket to exclude evidence the parties have already submitted, but which could no longer be considered. It is possible that the Commission would have to reopen the evidentiary phase of other proceedings, to allow for submission of new evidence and consideration of new standards called for in the bill.

QUESTIONS FROM SENATOR ROCKEFELLER

1. Please describe in detail how a small shipper could make use of the methodology used in the Omaha Public Power District case, as you testified, in order to present and prevail in a rate reasonableness case.

As I noted at the hearing before the subcommittee, the Interstate Commerce Commission (ICC) in its Omaha Public Power District decision has taken steps to make a stand-alone cost analysis simpler to perform. The decision by the full Commission in that case, affirming an even more detailed preliminary decision by an Administrative Law Judge, identifies methodologies and sources of information that shippers can use to meet the standards for a "Minimal Evidentiary Presentation" in a maximum rate case. Those methodologies include means for selecting a group of movements for which costs can be calculated, rather than just the traffic in question in a case, thus reducing the level of revenues the individual shipper has to contribute in order to cover costs. The decision presents, step by step, an example of a process for computing the basic costs of a movement, using variable cost data from the ICC's standardized costing system and the annual carload waybill statistics, as well as techniques suggested by the railroads and shippers to adjust the figures for the special characteristics of the particular traffic. For example, the ICC adopted a formula proposed by Omaha Public Power District for computing maintenance of way costs, called the speed factored gross ton formula (SFGT), which has been developed and used by shippers where those costs differ sharply depending on the characteristics of the line and the density of traffic. The ICC also describes in detail how the shipper dealt with many other elements of operating and capital costs, including line and equipment needs and cost of capital, to meet evidentiary standards.

The Department of Transportation does not generally intervene in individual rate cases at the ICC, but we do participate in rulemakings to develop the standards and procedures that will be applied in individual cases. In the comments we submitted to the ICC in Ex Parte No. 347 (Sub-No. 2), the proceeding to establish guidelines for regulating rates for non-coal shippers, the Department proposed that the ICC should go beyond the Omaha Public Power decision to provide assistance to small shippers in putting together the necessary cost evidence for a maximum rate case, and that the ICC should develop a simplified "surrogate" for stand-alone costs that shippers could use in such a case. We are also urging the Commission to work with railroads and shippers to formulate a fuller system of data and procedures for calculating those simplified surrogate stand-alone costs, building on the example of the Omaha Public Power case.

2. You testified that the ICC's revenue adequacy test considers every aspect of a railroad's financial health. Please describe how that test accomplishes this, and please explain why, in light of that feature of the ICC's test, you did not inform Congress of the results of that test as applied to Conrail and the Norfolk Southern Company, which derives 85 to 90 percent of its net operating income from its railroads, during the Conrail sale debates last year.

That very issue was raised a number of times during the Conrail sale debate and the Department did in fact address it in testimony and statements on the record to committees of the Congress (February 6, 1986, Staggers Act oversight hearing, House Commerce Committee; March 12, 1986, FRA budget hearing, questions submitted for the record, House Appropriations Committee; June 5, 1986, hearing on H.R. 1140, the Railroad Antimonopoly Act, House Commerce Committee).

In the discussion of the Conrail sale, we tried very carefully to distinguish between the concepts of profitability (in the sense of earning some positive income or "profit" in a particular time period) and the long run consideration of "revenue adequacy." The Department recognized that Conrail was generating profits, but we clearly noted that Conrail could not be considered to have attained a level of earnings that would be adequate in the long term.

While the Department described Norfolk Southern as "profitable" and "a very strong railroad," particularly in comparison to Conrail, we also recognized that Norfolk Southern was not yet earning adequate revenues according to the statutory standard. We noted that it was close to the revenue adequacy target; however, being a well run railroad cannot ensure that a company will be able to cover its basic costs, maintain plant and equipment, sustain the desired level of service, and attract capital at competitive prices for the long term, if its returns do not match the levels offered by alternative investment opportunities in the financial market. That is what the revenue adequacy standards are intended to address.

As the Department explained during the Conrail sale debate, the ICC's revenue adequacy test is designed to meet the Congressional mandate to establish standards for determining whether the revenues of individual rail carriers are sufficient to ensure safe efficient service and a sound transportation system over the long term. The statute, 49 U.S.C. 10704(a)(2), sets out a number of considerations that the Commission must take into account in reaching such a determination,* and we believe that the ICC's comparison of return on investment to the cost of capital meets the requirements to consider all of those various factors: coverage of operating expenses, depreciation and obsolescence, repayment of debt, and profit or return on capital employed in the business, sufficient to accommodate the effects of inflation and permit raising capital and making prudent capital investments.

During the last two years, the ICC as well as the Railroad Accounting Principles Board examined a number of modifications to the revenue adequacy standards and procedures, including several supported by DOT, to ensure that the results comport with the perceptions of the market and the actual ability of the carriers to attract and retain funds. The ICC has now adopted most of those modifications, which will have the effect of improving the individual railroads' revenue adequacy status. However, the Norfolk Southern still would not have been found revenue adequate in any recent year, and that would be true even if all of the revenue adequacy provisions of the CURE bill were adopted.

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* 49 U.S.C. 10704(a)(2) states:

> The Commission shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under that subchapter that are adequate, under honest, economical, and efficient management, to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business. . .
>
> Revenue levels established under this paragraph should--
>
> (A) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and
>
> (B) attract and retain capital in amounts adequate to provide a sound transportation system in the United States.

3. You testified that a finding of effective geographic competition from foreign sources with respect to a coal producer such as appears to be the case with Mr. William Skewes, a witness before this Committee, would not necessarily result in a finding of no market dominance in a rate reasonableness case at the ICC. Please identify and supply for the record any ICC rule, or decision, which supports the proposition that the ICC may find market dominance with respect to a domestic origin notwithstanding a finding of effective geographic competition from foreign producers of the same commodity.

Mr. William Skewes of Ridge Land Company, Gary, WV, testified to the Committee that he has previously sold coal to France and also to Turkey, and that the business has been lost to another domestic producer located on another railroad, in one case, and to Australian producers in the second case. The fact that the customers for the coal can obtain some or all of the supply they need from alternative sources, however, does not mean that the ICC would find geographic competition and therefore no market dominance in such a case.

The issue in a market dominance determination is whether there is "effective competition," which the ICC has defined as "pressures on [a] firm [providing a good or service] to perform up to standards and at reasonable prices or lose desirable business." Market Dominance Determinations, 365 I.C.C. 118, 129 (1981), aff'd, Western Coal Traffic League v. United States, 719 F.2d 772 (5th Cir. 1983) (en banc), cert. denied, 104 S. Ct. 2160 (1984). The critical word is "effective"--to find that a railroad does not have market dominance, the ICC must determine that competitive forces effectively constrain the freight rates that must be paid for the shipper's traffic. As the Commission has noted in formulating its own decisions on market dominance, the Court stated in Arizona Public Serv. Co. v. ICC, 742 F.2d 644, 650-51 (D.C. Cir. 1984):

> At the core of the "effective competition" standard is the idea that there are competitive, market pressures on the railroads deterring them from charging monopoly prices for transporting goods. Of course, any such effective competition will always be relative to a particular price that the railroads charge. . . . The mere existence of some alternative does not in itself constrain the railroads from charging rates far in excess of the just and reasonable rates that Congress thought the existence of competitive pressures would ensure. (Emphasis in original.)

As an example of this point, in Docket No. 37809, McCarty Farms, et al. v. Burlington Northern, Inc., _____ I.C.C. 2d _____, a case brought by Montana producers of wheat and barley, the ICC found that the railroad had market dominance over the traffic despite the existence of a number of alternative geographic sources that could supply overseas customers with grain in competition with Montana grain. The Commission noted that tariff rates for Montana barley are higher than those for wheat, and that the tariffs rates on Montana wheat are substantially above the rates charged for non-Montana wheat, as well as above the BN's costs of providing the service. While such evidence alone does not prove market dominance, it may help to assess the question of whether competition is effective in keeping rail rates below a reasonable maximum level.

On the other hand, of course, the fact that one originator of traffic loses business to a competitor or that higher freight rates are charged for one movement than for a movement of the same commodity from some other source to the same point (domestic or overseas) does not mean that the railroad has market dominance or that there is an abuse of market power. Those circumstances alone would not be determinative either of the rate reasonableness or market dominance questions. Additional evidence would have to be considered on the details of the particular case for the ICC to make a decision on whether or not competition is effective. Under the ICC's rules--adopted at shipper's urging in 1985 in Ex Parte No. 320 (Sub-No. 3), Product and Geographic Competition--if the railroad wishes to have the Commission consider geographic or product competition in a case, the railroad has the burden of proving the existence and effectiveness of those forces.

4. You testified that you would be willing to examine whether setting time limits might be an effective means of improving the rate reasonableness process at the ICC. There are rather strict and unavoidable time limits already in the law, and these obviously do not work. What other procedural improvements would you suggest or recommend for our consideration, and have you made any such suggestions in any pleadings or filings at the ICC?

In fact, although the law establishes time limits on some levels and phases of ICC decisionmaking, the time limits pertain only to the amount of time an Administrative Law Judge may take in hearing and deciding a case, and to the time allowed for appeal of an ALJ or Review Board decision. In addition, the Commission can extend all these deadlines as long as it notifies the Congress. And there are no time limits on the Commission itself, when it either issues the initial decision on a case or hears an appeal of its own decision or reconsiders a case remanded by a court.

We are actively exploring the question of procedural measures including deadlines at the ICC that would improve the responsiveness of the rate process to complaints from shippers. As part of that effort, my staff has reviewed the record for eight rate reasonableness determinations. It appears that one major reason for delay in reaching decisions in the past should not be a concern in the future. Several of the cases we examined were held in abeyance pending the ICC's adoption of maximum rate guidelines; guidelines are now in place for coal, and have been upheld in the courts. Similarly, guidelines are being developed for all other commodities. In previous years, when the ICC's earlier proposed guidelines were being challenged in court or the case decisions themselves were being appealed, the time required for litigation added further to the delays. The bulk of the remaining time spent in the eight cases we examined was in the initial stages. Often, it appeared that a case was not assigned to an ALJ for a considerable period. Additionally, the record-building stage of the proceeding generally took well over the amount of time specified in the statute. Often, however, the delays came at the request of the parties, who asked for additional time to develop new evidence or to negotiate a solution on their own.

Requiring prompt assignment of cases, and placing time limits on determinations made by the full Commission, and on ICC reconsideration of appealed and remanded cases, could expedite the regulatory process. Additionally, there may be ways to shorten the evidentiary phases of proceedings without depriving the parties of their rights to present and refute evidence. My staff is continuing to pursue this issue, through discussions with shippers and carriers about the best ways to ensure that this phase of a rate case is thorough but not prolonged.

Finally, as experience with the maximum rate guidelines grows, we expect that presentation of cost evidence will become much more routine and less time-consuming. We have recommended to the Commission that it develop a simplified methodology and standardized rail costs for use in estimating stand-alone costs in rate reasonableness cases so that lengthy and expensive special cost studies and evidence-building would not be necessary.

5. Do you believe any parts of the railroad legislation presently pending before the Canadian Parliament would be usefully applied in this country? Please provide an explanation of your answer.

The Canadian rail legislation is designed for a transportation system with only two major carriers and relatively little truck or water competition compared with the U.S. In addition, under the regulatory system in Canada since 1967, the Canadian Transport Commission has not intervened as often or as actively in maximum rate disputes as the ICC does. The new Canadian legislation establishes a new regulatory agency with authority to take a more active role more like that of the ICC, and several new tools that are intended to promote reliance on competition and negotiation and to protect shippers from unreasonable rates and services. The Staggers Act also balances those two purposes. Building on the existing system of regulation in this country, the Staggers Act retained the ICC's authority to review and prescribe rates, while allowing the market to govern where it can efficiently constrain rates. Because of the difference in the structure and emphasis of our two systems, I do not think that any of the provisions of the Canadian legislation could be adopted unchanged.

It is possible that the provision in the Canadian legislation requiring arbitration of rate disputes at the request of a shipper could be adapted to provide a means of resolving maximum rate cases in an expedited manner. To work successfully in the U.S., arbitration in most cases would have to be entered into voluntarily by both parties. Such an alternative has been shown to be very useful in resolving shipper-railroad disputes over freight claims, and there is nothing to stop its use by parties to a rate dispute. However, the ICC could not administer a system of arbitration as part of its rate reasonableness responsibility under the present law, and it is not clear that an arbitrated settlement would meet the present statutory and judicial requirements for a "just and reasonable" rate. We also believe it would be necessary to prohibit the Commission from allowing a party to get "two bites of the apple" -- i.e. pursuing a case at the Commission if it were not satisfied with an arbitrator's award. Under current law, we believe the Commission cannot refuse to take such a case.

QUESTIONS FROM SENATOR DANFORTH

1. On June 17, 1987, executives from several major railroads testified that they are investing more in their rail business than they are earning from that business. This high level of investment benefits shippers and I take it from your testimony that it improves safety. What would the CURE bill do to rail investment, shipper service and safety?

I believe that the CURE bill would have a disastrous effect on rail investment, for several reasons. It would have a direct adverse effect on industry revenues, through the artificial restrictions it seeks to put on rates, and through the costly regulatory proceedings it would generate. Additionally, the so-called competitive access provisions of the bill would require introduction of a second rail carrier into markets where it may not be possible for more than one railroad to exist and still cover its costs. With the reduction in revenues represented by these provisions, railroads would find it difficult to generate sufficient cash to sustain high levels of investment. Moreover, the restrictions contained in the bill would discourage additional investment, because the prospects for generating even a minimally adequate return would be dim, given the lack of ratemaking flexibility and the requirement for shared access.

As a result, service to shippers would decline. Carriers would find themselves less able to invest adequate amounts in plant and equipment to retain business, and would be reluctant to commit funds for projects where future traffic and rate levels were uncertain. We would also lose the significant gains in safety that have characterized the years since 1980. FRA staff research has found that, in the period between 1980 and 1985, a one percent increase for road and track expenditures was associated with a 5.8 percent decline in track-related accidents. While it is not possible to say that the same relationship would hold in the reverse case, it is reasonable to assume that safety levels would fall if investment were curtailed, as it surely would be as a result of the CURE bill.

2. Much of CURE is directed at captive shippers. How large is the captive shipper problem and what effect would CURE have on non-captive shippers?

At most, the amount of traffic that would qualify for "captive shipper" protection under the jurisdictional threshold in either the CURE bill or the Staggers Act represents 10-15 percent of rail traffic, and that share is fairly consistent for all major commodities. This may be a significant overstatement, because it covers all traffic with rates at or above the threshold for ICC jurisdiction, and many shippers in this group are protected by competition. There is no way to tell whether or not a shipper is actually "captive" to a railroad without examining the circumstances of a particular case.

The magnitude of the "problem" faced by captive shippers is even smaller. Although many shippers took advantage of the savings provision of the Staggers Act to challenge rates in effect in 1980, the vast majority of those cases have been closed, either through settlement by the parties or because the complaint was withdrawn by the shipper. Aside from these Section 229 cases, very few protests have been filed at the Commission over the past few years -- some 30 in 1985 out of 63,000 tariffs filed, and only 17 in 1986 out of 79,000. In contrast, the CURE bill would have a drastic effect on all shippers, by curtailing the ability and incentive of carriers to offer innovative rates and services, by encouraging reliance on the ICC to resolve disputes, by requiring a return to outmoded ratemaking and other regulatory practices that would increase the burdens on railroads and shippers, and by reducing the financial resources and thus the service capacity of the carriers.

The bill would artificially increase the number of shippers considered to be captive, by prohibiting ICC consideration of any evidence of product or geographic competition in market dominance decisions. This would mean that rates that under present law are determined in the competitive marketplace, would be returned to the regulatory arena. Similarly, the competitive access provisions would reverse the intent of the Rail Revitalization and Regulatory Reform Act of 1976, requiring the Commission to set rail rates even when there is ample evidence of truck or barge competition. These two provisions alone would put a substantial amount of rail traffic back under the ICC's jurisdictional authority.

The access provisions would actually discourage intramodal competition, and raise rates for shippers, by thwarting the railroads' efforts to lower costs through route restructuring. The lower costs associated with high volume and efficient routings are now being passed along to shippers in the form of lower rates. The CURE bill would require that all routes between the same points be "equalized" with respect to rate-to-cost ratios, at the request of a shipper or another carrier. Railroads will be very reluctant to offer discounts to shippers who use efficient routings if those reductions must also be applied to routes where the level of traffic does not permit the same cost savings. Promotion of such inefficient routes may in fact raise overall costs, since the savings associated with concentration of traffic will evaporate.

Finally, the CURE bill's aim of severely restricting the railroads' ability to price differentially will significantly affect all shippers, both captive and non-captive. By limiting the carriers' ability to spread fixed and common costs over all traffic according to demand for rail services, the bill would force the railroads to forgo higher contributions from some shippers, and in exchange try to raise contributions elsewhere, thus driving away the traffic that has more attractive options. Those remaining shippers, who must depend on rail services, would see their rates rise to cover the share of joint costs formerly borne by shippers now using trucks or barges. The rail system and the overall level of service would be pared back, as the amount of traffic dropped and the revenues available for reinvestment in the system eroded. Maintenance, new investment, even the progress in improving railroad safety, all would suffer, and every rail shipper would feel the effect of that loss.

3. Are there alternatives to the CURE bill for captive shippers? Could procedural reforms assist these shippers?

We believe that administrative actions to implement the provisions of the existing law and to inform shippers of their options under the law can provide effective protection for "captive shippers" from unreasonable railroad rate and service actions. We have pointed out the methodological steps contained in the ICC's decision in the Omaha Public Power District coal rate case which can be applied by other shippers to help them prepare a rate complaint case.

We are also concerned that assembling the evidence to make such a presentation may be costly and difficult when a firm ships small volumes of freight by rail and has little exposure to the data or regulatory procedures. Therefore, the Department proposed in our comments to the ICC in Ex Parte No. 347 (Sub-No. 2), the rulemaking concerning rate guidelines for non-coal traffic, that small shippers should be provided assistance in preparing cost evidence for use in such a case, and that shippers, railroads, and other interested parties should work together to compile the most up-to-date, accurate data possible for use in meeting that objective.

The Department is also actively involved in investigating whether modifications to the timetables imposed on ICC decisionmaking might help to make the protections already provided by the Staggers Act more readily available and help to alleviate the problem of delays in obtaining final decisions from the ICC in individual rate cases.

QUESTION FROM SENATOR PRESSLER

1. Let me ask a question about competitive access. How would the CURE bill's treatment of competitive access affect the industry and shippers?

The competitive access provisions of the CURE bill would not only threaten the flexibility and incentive for railroads to establish the most efficient and competitive price and service options; they would also remove the ICC's discretion to review market circumstances and all other considerations in determining whether or not a particular joint rate or other access option is appropriate. The bill would thereby prevent the Commission from distinguishing the cases in which competitive access would serve the public interest from those in which the effect would be precisely the opposite. As a policy, it makes no more sense to mandate additional access in every case than to bar competitive access in every case.

One provision of S. 676 would make it mandatory for the Commission to order reciprocal switching, terminal trackage rights, and establishment or preservation of joint rates and routes, where today the authority is discretionary. There are cases where the future volume of rail traffic may be sufficient to sustain multiple carriers, and introduction of a second railroad can result in efficient and attractive service and rates. The Powder River Basin in Wyoming is the best example; in that situation, the total volume of freight is very high and has continued to grow since entry of a second railroad. Both carriers in the Basin have been able to operate efficiently and profitably in direct competition with each other. On the other hand, where volumes are not large and have little potential to grow, adding an additional carrier would simply mean that a small traffic base would be further diluted. One more carrier would have to run trains to the same points and shippers, with the associated expense of equipment and crews, adding to the total costs of serving the lines. Thus, by dividing the same amount of traffic among multiple carriers, the unit costs of rail service would increase. That would either force up rail rates or force down rail earnings and deny the carriers the revenues necessary to maintain plant and equipment and sustain the quality of service. Neither outcome would serve the railroads' customers.

In addition, under the CURE bill, if the carriers involved in a competitive access case for trackage rights or reciprocal switching could not agree on the level of compensation to be paid for the access, the ICC would be required to set the fees, according to statutorily prescribed standards. The bill would constrain the fees to be no higher than a particular formula. The mandated fee levels would not only threaten to deny railroads adequate compensation, but could also produce additional inefficiencies in resource use, by encouraging traffic to be routed in accordance with prices unrelated to the overall capital and operating costs involved.

S. 676 would also require a railroad, at the request of a shipper, to establish a rate for a joint-line routing pegged to the rate on the lowest cost single-line route between the same two points. Again, where traffic densities in the corridor involved are too low, the joint routings are not efficient, or there is already vigorous competition from other modes, it may not serve the public interest to require additional rail options to be introduced or preserved. Such a policy would encourage a return to the pre-1980 practice of maintaining multiple and often redundant routings between two points, with all the attendant costs of duplicative investments in track and operations, when handling the traffic on fewer, higher density routes would permit lower costs and lower rates to shippers.

The bill would promote a structure of rates equalized at the rate-to-variable cost ratio represented on the single-line route between the two points involved. If the single-line route had substantially lower variable costs than any other route, the proposal might not actually lead to any significant use of competing routes, but only restrict the carrier's and the ICC's discretion to establish efficient, market-sensitive rates. However, if several competing routings had similar variable costs--though not necessarily similar fixed or total costs--the CURE bill could force railroads to charge comparable rates on all of those routings and divide traffic among them, thus incurring a higher level of overall costs for operations, maintenance, and investment. The result might well be higher rates on all the routings, to allow recovery of the costs on the least efficient routes.

Thus, while CURE's competitive access provisions could drive railroads to lower some rates in the short run to meet the new statutory standards or to try to build traffic levels, in the long run, the effect would be costly to shippers and carriers. And in the short or long run, the provisions would reduce an individual railroad's ability to make the most efficient use of its plant and equipment and to offer the most competitive combination of rates and services to its shippers.

Forcing a company to permit use of its own property at prescribed rates, particularly in order to allow a competitor to vie for the business, is undoubtedly one of the most intrusive actions the government can take against a private business. In the guise of attempting to create and maintain intrarailroad competition, the CURE bill and other similar proposals threaten a radical restructuring of the physical nature and operation of the rail system, and a reversal of the Staggers Act policy to minimize reliance on government interference in resolving issues between railroads and shippers. We believe this would be an ill-advised and unjustified step. Ultimately, it would be destructive to the progress the railroads have made since 1980 in becoming more efficient and competitive participants in the national transportation system. When circumstances and the most effective means for addressing them differ so widely between individual cases, the regulatory agency must be given the discretion to develop solutions that will best meet the public interest in the particular situation. Removal of that discretion would hurt the very shippers that competitive access was intended to help.

/The following information was requested at page 436._/

Three subjects have been raised:

1. the sale of Conrail
2. railroad revenue adequacy
3. rate protection for "captive shippers"

The Department's recommendation to sell the Government's interest in Conrail to the Norfolk Southern Corporation was based on three public interest criteria: to best preserve service to shippers and communities, to leave Conrail in the strongest financial position after the sale, and, consistent with the other two criteria, to maximize the return to the taxpayers. Secretary Dole determined that those objectives were most likely to be met by selling Conrail to a single buyer committed to running the railroad. Among the 15 bids received, the Secretary selected the bid made by Norfolk Southern as the one that best met the established criteria. The Norfolk Southern bid represented the greatest financial strength and security for Conrail operations, the best guarantee of preserved and enhanced service to shippers and communities in the Conrail region, and the highest return to the Federal Treasury and the public.

We recognized that the Norfolk Southern railroad system was not considered by the ICC to be earning an adequate return on its railroad investments for the long term, although it was among the strongest and most profitable of the railroads. Conrail was only marginally profitable and was extremely vulnerable to swings in the business cycle. However, the synergies created by the integration of Conrail into Norfolk Southern--increased single-line access to key markets, shorter and more direct routes for some shippers, consolidated marketing and operations, and a more balanced traffic base--would have brought increased financial strength to the combined systems. Norfolk Southern proposed to make the purchase using cash it had on hand, as well as some borrowing, which it could attract based on the favorable earnings prospects for the Norfolk Southern-Conrail combination. The fact that a company can and does borrow money does not indicate that its present investments, operations, and earnings meet the standards for long-term financial health; it just reflects that the lenders have concluded that a specific loan can be repaid.

Similarly, profitability is not synonymous with revenue adequacy. Any company that reports any measure of positive net income in a financial reporting period is defined as "profitable." In contrast, the goal of adequate revenues for railroads, established by the Congress in the Railroad Revitalization and Regulatory Reform Act of 1976 (the 4R Act), is based on recognition of the fact that railroads must move toward a long-run level of earnings sufficient to cover not only current operating expenses and fixed charges, but also vital investments in plant and equipment and a rate of return comparable to those available on competing investments. If a railroad cannot offer competitive rates of return to debt and equity investors, it will not be able to attract and retain the capital needed to sustain quality service and meet the demands of shippers and the broader economy. It would be counterproductive to deny a carrier that is not yet revenue adequate the ability to borrow and invest funds for purposes of enhancing its financial prospects and improving service capacity.

In the same way, it would not make sense to impose tighter rate regulation on a railroad in that situation. ICC rate decisions need to take into account that a railroad must cover its overall costs in order to survive. The Staggers Act explicitly added revenue adequacy to the factors that must be considered by the Commission in reaching a maximum rate determination. The Department's view is that if a railroad has achieved adequate revenues, the ICC should apply stricter standards in reviewing its rates on "market dominant" traffic, and that a "captive shipper" should not have to bear higher rates to enhance already adequate earnings. This is far different, however, from forcing a revenue inadequate railroad to curb or reduce its rates at the same time it is incurring additional costs to improve the strength and stability of its service. A carrier would not be able to reach the revenue adequacy goal if progress on one front were offset by public policies that eroded any gains.